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Audits of employee benefit plans with conforming changes as of May 1, 2000; Audit and accounting guide:

American Institute of Certified Public Accountants. Employee Benefit Plans Committee

AUDITS OF EMPLOYEE BENEFIT PLANS With Conforming Changes as of May 1, 2000

AICPA

AICPA AUDIT AND ACCOUNTING GUIDE

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Audits of Employee Benefit Plans

With Conforming Changes as of May 1, 2000

This edition of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which was originally issued in 1991, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page iv). The changes made are identified in a schedule in appendix L of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Employee Benefit Plans Committee on the application of generally accepted auditing standards to audits of financial statements of employee benefit plans. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for employee benefit plans. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

The Employee Benefit Plans Committee gratefully acknowledges the contributions of Melissa A.R. Krause, former committee member; Susan W. Hicks; Daniel J. Cronin; The Office of Chief Accountant, Pension and Welfare Benefits Administration; and the Office of the Inspector General, U.S. Department of Labor.

This guide has been updated to reflect guidance relevant to employee benefit plans contained in official pronouncements:

FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of Effective Date of FASB Statement No. 133*

FASB Interpretation No. 43, *Real Estate Sales*

Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*

SAS No. 90, *Audit Committee Communications*

SOP No. 99-3, *Accounting for and Reporting of Certain Defined Contribution Pan Investments and Other Disclosure Matters*

EITF Consensuses adopted through the January 2000 Emerging Issues Task Force (EITF) meeting

Preface

This guide has been prepared to assist the practitioner in preparing, auditing, and reporting on financial statements of employee benefit plans, including defined benefit pension plans, defined contribution plans, and employee health and welfare benefit plans. This guide applies to audits of financial statements of employee benefit plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as well as those that are not. Appendix A identifies and summarizes relevant Employee Retirement Income Security Act of 1974 (ERISA) requirements and regulations.

Generally accepted auditing standards and accounting principles are applicable in general to employee benefit plans. The broad application of those standards and principles is not discussed here. Rather, the guide focuses on the special problems in auditing and reporting on financial statements that are unique to employee benefit plans.

The guide contains certain suggested auditing procedures, but detailed internal control questionnaires and audit programs are not included. The nature, timing, and extent of auditing procedures are a matter of professional judgment and will vary depending on the size, organizational structure, internal control, and other factors in a specific engagement.

The guide also includes information regarding statutory rules and regulations applicable to employee benefit plans and illustrations of plan financial statements and auditors' reports. The Department of Labor, Pension and Welfare Benefits Administration strongly encourages the use of this guide in meeting the requirements contained in ERISA section 103 that a plan have an audit conducted in accordance with generally accepted auditing standards.

The guidance in this audit guide is in certain respects more detailed than that generally included in other AICPA audit guides. To facilitate reference, paragraphs have been numbered.

Generally Accepted Accounting Principles

In March 1980 the Financial Accounting Standards Board (FASB) issued Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. In August 1992 the FASB issued Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, which amends FASB Statement No. 35. FASB Statements No. 35 and 110 do not, however, apply to defined contribution plans and employee health and welfare benefit plans.

Chapters 3 and 4 of this guide describe the specialized accounting principles and practices for defined contribution plans and employee health and welfare benefit plans, respectively. The accounting guidance in those chapters is consistent with the accounting and reporting standards in FASB Statement No. 35 to the extent that this is appropriate.

In August 1992, Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, was issued which clarifies several accounting and reporting requirements set forth in chapter 4 and updates the guide to incorporate new statements issued by the FASB. The SOP is effective for audits of single-employer plans with more than 500 participants for plan years beginning after December 15, 1992; for audits of single employer plans with no more than 500 participants for plan years beginning after December 15, 1994; and for audits of multiemployer plans for plan years beginning after December 15, 1995. Earlier adoption is encouraged. When a plan adopts the SOP, it must be adopted in its entirety.

In September 1994, SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plan,* and Practice Bulletin (PB) 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans,* were issued. SOP 94-4 specifies the accounting for health and welfare benefit plans and defined-contribution plans for investment contracts issued by either an insurance enterprise or other entity. The SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of the SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995. Earlier adoption is encouraged. PB 12 provides clarification of the reporting requirements in paragraph 3.28*k* of the guide and is effective for plan years beginning after December 15, 1993.

In July 1999, SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans,* was issued. SOP 99-2 amends chapters 2 and 4 of the guide and specifies the accounting for and disclosure of 401(h) features of defined benefit pension plans, by both defined benefit pension plans and health and welfare benefit plans. The SOP is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively by restatement of financial statements for prior periods.

SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters,* was issued in September 1999, and amends chapters 3 and 4 of the guide, SOP 94-4, and SOP 92-6. SOP 99-3 simplifies disclosures for certain investments and supersedes AICPA Practice Bulletin 12 (PB 12). This SOP is effective for financial statements for plan years ending after December 15, 1999 with earlier application encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by-fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* supersedes FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* and FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.* FASB Statement No. 133 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105, with modifications.

FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000.

The FASB established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site http://www.fasb.org.

Effective Date

The provisions of this guide are effective for audits of financial statements for plan years beginning after December 15, 1990. The provisions of this guide should also be applied in audits of financial statements for earlier plan years when such audits are performed concurrently with audits for plan years beginning after December 15, 1990.

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Chapter 1

Introduction and Background

1.01 The purpose of this guide is to provide guidance on accounting, auditing, and reporting on the financial statements of employee benefit plans (plans). This guide applies to defined benefit pension plans, defined contribution pension plans, and defined benefit and defined contribution health and welfare benefit plans. In the United States, there are approximately 731,000 private pension plans and 9 million health and welfare benefits. The private pension plans alone cover approximately 76.4 million participants and include assets of more than $1.67 trillion.

1.02 This guide applies to audits of financial statements and supplemental schedules, as applicable, of plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as well as to those that are not. The recommendations contained in this guide apply to the financial statements of plans sponsored by commercial or not-for-profit private sector entities. The accounting provisions of this guide are not intended to apply to governmental employee benefit plans. The accounting for those plans is prescribed by Governmental Accounting Standards Board (GASB) Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*; however, portions of the guide may be useful to auditors of those plans. The guide discusses accounting, auditing, and reporting for ongoing and terminated plans. A plan is the reporting entity as defined under ERISA and Financial Accounting Standards Board (FASB) Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*. Although this guide does not specifically discuss accounting, auditing, and reporting for employee benefit trusts as separate entities, it may be useful to auditors reporting on employee benefit trusts.

1.03 The guidance presented is not all-inclusive, but rather is limited generally to matters that warrant special emphasis or that experience has indicated may be useful. This guide bases on the assumption that the readers are generally expert in accounting and auditing and focuses on specific problems of auditing, accounting, and reporting with respect to the financial statements of employee benefit plans. Accordingly, the guide does not discuss the application of all generally accepted accounting principles and auditing standards as they pertain to the auditing of such financial statements. The nature, timing, and extent of auditing procedures are matters of professional judgment and will vary according to the size of the plan, the plan operations and administrative structure, the auditor's assessment of the level of risk, and other factors. The independent auditor is also expected to be familiar with applicable governmental laws and regulations.

1.04 *Defined benefit pension plans* provide a promise to pay to participants specified benefits that are determinable and are based on such factors as age, years of service, and compensation.

1.05 *Defined contribution pension plans* provide an individual account for each participant and provide benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience, and (*c*) any forfeitures allocated to the account, less any administrative expenses charged to the plan. These plans, which are discussed in more detail in chapter 3, include (*a*) profit-sharing plans, (*b*) money purchase pension plans, (*c*) stock bonus and employee stock ownership plans (ESOPs), (*d*) thrift or savings plans including 401(k) arrangements, and (*e*) certain target benefit plans.

1.06 *Health and welfare benefit plans,* which are discussed in more detail in chapter 4, include plans that provide (*a*) medical, dental, visual, psychiatric, or long-term health care; severance benefits; life insurance; accidental death or dismemberment benefits; (*b*) unemployment, disability, vacations or holiday benefits; and (*c*) apprenticeships, tuition assistance, day-care, housing subsidies, or legal services benefits. Health and welfare benefit plans may be either defined-benefit or defined-contribution plans, as explained in the following paragraphs and in more detail in chapter 4:

a. Defined-benefit health and welfare plans specify a determinable benefit, which may be in the form of reimbursement to the covered plan participant or a direct payment to providers or third party insurers for the cost of specified services.

b. Defined-contribution health and welfare plans maintain an individual account for each plan participant. Such plans have provisions that specify the means of determining the contributions to participants' accounts, rather than the amount of benefits the participants are to receive.

Financial Accounting and Reporting Standards

1.07 FASB Statement No. 35, issued in March 1980, established standards of financial accounting and reporting for financial statements of defined benefit pension plans but did not establish standards for defined contribution or health and welfare benefit plans. This Audit and Accounting Guide provides guidance on certain accounting, auditing, and reporting matters considered unique to employee benefit plans, including defined contribution and health and welfare benefit plans. SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, was issued August 3, 1992 and is amended by SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*. SOP 92-6, as amended, has been incorporated into chapter 4 of this guide.

1.08 SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans,* was issued in September 1994, and is amended by SOP 99-3. SOP 94-4, as amended, has been integrated into chapters 3, 4, and 7 of this guide.

1.09 SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, was issued July 1999 and has been integrated into chapters 2, 4 and appendixes D and F of this guide. SOP 99-3 was issued in September 1999, and has been integrated into chapters 3, 4 and appendix E of this guide.

1.10 Employee benefit plans that are subject to ERISA are required to report certain information annually to federal government agencies—that is, U.S. Department of Labor (DOL), Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC)—and to provide summarized information to plan participants. For many plans, the information is reported to the IRS on Form 5500, *Annual Return/Report of Employee Benefit Plan*, which includes financial statements prepared in conformity with generally accepted accounting principles and certain financial schedules (for example, plan investments and reportable transactions).

Governmental Regulations

1.11 Various provisions of the Internal Revenue Code (IRC) affect employee benefit plans and trusts established pursuant to employee benefit plans. If an employee benefit plan and its underlying trust qualify under section 401(a) of the IRC, certain tax benefits are available, including (*a*) current tax deductions by plan sponsors for contributions, subject to certain limitations; (*b*) deferment of income to participants until the benefits are distributed; (*c*) exemption of the trust from income taxes, other than tax on unrelated business income; and (*d*) favorable tax treatment of certain benefit distributions to participants or their estates. Special rules apply to nonqualified plans and trusts depending on whether the plan is funded or unfunded. Generally, qualified plans provide benefits to relatively broad groups of employees, whereas unqualified plans provide benefits to only a few key employees and may not be currently funded. Generally, ERISA preempts state laws and regulations (see discussion of ERISA in appendix A).

Reporting and Disclosure Requirements

1.12 ERISA provides for substantial federal government oversight of the operating and reporting practices of employee benefit plans. In addition to establishing extensive reporting requirements for covered plans, ERISA establishes minimum standards for participation, vesting, and funding for defined benefit and defined contribution plans sponsored by private entities. It also establishes standards of fiduciary conduct and imposes specific restrictions and responsibilities on fiduciaries.

1.13 Under ERISA, the DOL and the IRS have the authority to issue regulations covering reporting and disclosure requirements and certain administrative responsibilities. The PBGC guarantees participants in most defined benefit pension plans against the loss of certain pension benefits if the plan terminates, and it administers terminated plans in certain circumstances.

1.14 Appendix A describes which plans are covered by ERISA and pertinent provisions of ERISA and related reporting and disclosure regulations issued by the DOL. Additional guidance concerning the effects of the IRC, ERISA, and related regulations on the operating and reporting practices of employee benefit plans is discussed throughout this guide.

1.15 Section 104(a)(4) of ERISA describes the power of the DOL to reject reports, including the authority to change auditors. Section 107 of ERISA requires that working papers supporting audits of employee benefit plans be kept for a period of six years. Section 502(c)(2) of ERISA describes the substantial penalties that may be assessed by the DOL (see appendix A).

Audit Requirements

1.16 ERISA contains a requirement for annual audits of plan financial statements by an independent qualified public accountant. Generally, plans with 100 or more participants (see appendix A) are subject to the audit requirement. The independent auditor's objective and responsibility, under generally accepted auditing standards (GAAS), are to express an opinion on whether the financial statements are fairly presented in conformity with generally accepted accounting principles, and that the related supplemental information is presented fairly, in all material respects, when considered in conjunction with the financial statements taken as a whole. It should be recognized that although the audit requirement in ERISA is an important part of the total process designed to protect plan participants, a GAAS audit is not designed to ensure compliance with ERISA's provisions. Under the law, plan administrators, the IRS and the DOL have responsibility to ensure such compliance. The annual report and the financial statements prepared by the plan administrator and the independent auditor's report all contribute to the monitoring activities of these parties and agencies. An audit is an important discipline on the financial information reported by the plan administrator, but it does not ensure compliance with all legislative and regulatory requirements.

Operation and Administration

1.17 Employee benefit plans vary by basic type (defined benefit pension plans, defined contribution plans, and defined benefit and defined contribution health and welfare benefit plans) and by basic operating and administrative characteristics. Employee benefit plans may be single employer plans or multiemployer plans.[1] The most distinguishing characteristic between single employer plans and multiemployer plans is administration. Single employer plans are generally established by the management of one employer (or a controlled group of corporations) either unilaterally or through collective bargaining. In a single employer plan, the employer is the plan sponsor. By contrast, multiemployer plans are normally negotiated and established pursuant to a collective bargaining agreement between an associated group of employers, such as in the construction trades, and the union representing the employees. The plan sponsor of a multiemployer plan, with whom ultimate administrative responsibility rests, is a joint employer/union board of trustees.

1.18 Contributions may be required from both employers and participants (contributory plans) or from employers only (noncontributory plans). Noncontributory plans may contain provisions for payment of contributions or premiums by participants to maintain their eligibility during periods of unemployment; they may also provide for voluntary contributions by participants.

1.19 Plans may be funded through accumulated contributions and investment income (self-funded plans), funded through insurance contracts (insured plans), or funded through a combination of both (split-funded plans).

1.20 Employee benefit plans are normally established and maintained by plan sponsors pursuant to plan instruments. The provisions of plan instruments normally deal with such matters as eligibility to participate, entitlement to benefits, funding, plan amendments, operation and administration of plan provisions, identification of the plan's named fiduciary and allocation of responsibilities among those who also serve in the capacity as fiduciaries for

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[1] ERISA defines the term "multiemployer plan" as a plan to which more than one employer is required to contribute, that is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and that satisfies other requirements that may be prescribed by DOL regulations. As used in this guide, the term "single employer plan" may include plans with more than one employer under common control.

control and management of the plan, and delegation by fiduciaries of duties in connection with administration of the plan. A plan subject to ERISA is required to be in writing. The IRS has prepared and updated standard (master or prototype) plans that are available to plan sponsors and may be qualified by simplified procedures. In addition, standardized (or pattern) plans that have IRS approval are available from various sources.

1.21 The named fiduciary is responsible for the operation and administration of a plan including the identification of a plan administrator. This individual is usually an officer or other employee of the plan sponsor and typically reports to the plan sponsor's board of directors or management. Sometimes the named fiduciary is a trustee and a union representative. The named fiduciary has continuing responsibility for operation of the plan in accordance with the terms of the plan instrument, any trust instrument or insurance contracts, and government laws and regulations. Generally, the named fiduciary makes policy decisions concerning such matters as interpretation of the plan provisions, determination of the rights of participants under the plan, management of investments, and delegation of operational and administrative duties.

1.22 Although the named fiduciary retains responsibility for oversight of the plan, the plan's day-to-day administration (for example, collection of contributions, payment of benefits, management of cash and investments, maintenance of records, and preparation of reports) generally is allocated to one or more of the following: (*a*) the plan sponsor; (*b*) a trustee, such as a bank trust department; (*c*) an insurance company; (*d*) an investment advisor; or (*e*) the person or persons designated as the plan administrator or administrative agent.

1.23 In self-funded plans, the plan assets typically are managed in accordance with a trust instrument that sets forth, among other matters, the authority and responsibilities of the trustees and any investment advisors and managers. In insured plans, the plan assets typically are managed in accordance with an agreement that sets forth the duties and responsibilities of the insurance company.

Accounting Records*

1.24 As with other entities, the accounting records of employee benefit plans should produce information necessary for effective management and reliable financial reporting. The complexity of a plan's accounting records will vary with such factors as the type of plan, number of employer contributors, complexity of the benefit formula, variety of benefit payment options, and delegation of administrative duties.

1.25 The accounting and other plan records of employee benefit plans often are maintained at several locations. Depending on the type of plan, the allocation of fiduciary responsibilities, and the delegation of administrative duties, records may be maintained by trustees, insurance companies, consulting actuaries, service bureaus, the plan administrator, contract administrators, and plan sponsors. The records of plans including, among others, the basic accounting records, generally should include—

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* Many plans offer their participants direct access to the service organization by telephone or by electronic means (such as, internet or intranet). Often, the plan sponsor does not maintain independent accounting records of transactions initiated through these media.

a. *Investment asset records.* ERISA requires detailed reporting of investment assets including reportable transactions, party in interest transactions, and leases and loans in default.

b. *Participants' records.* Records should be maintained to determine each employee's eligibility to participate in the plan and receive benefits. Eligibility for participation and benefits may be based on such factors as length of service, earnings, production, and contributions, and can be affected by age or breaks in service. These records are generally part of or derived from the personnel and payroll records maintained by the employer or the plan. These records are often made available to the plan's actuary to be used in computing various amounts including amounts to be funded.

c. *Contribution records.* Separate contribution records should be maintained for each plan contributor to record payments and accumulated contributions and to determine delinquencies and errors. These records should provide sufficient detail to record contributions and payments received from a number of employers according to pertinent agreements or from individual participants.

d. *Claim records.* Claim records for health and welfare plans are generally extensive. They are used for such purposes as determining when benefit limits, if any, are reached by individual claimants and accumulating various historical data regarding types and amounts of claims, amounts paid, and timing of claims.

e. *Distribution records.* Records should be maintained to support all distributions. These records should identify entitlements, amounts, payment commencement data, terminations, forfeitures, transfers, and information to determine the tax consequences of distributions.

f. *Individual participants' account information.* ERISA requires information that reflects each plan participant's share of the total net assets of the plan be maintained. Changes in the value of net assets are allocated to the participants' accounts in accordance with the terms of the plan instrument. This information, which is not part of the basic books and records of a defined contribution plan, should necessarily be in agreement with the aggregate participant account information contained in the basic books and records.

g. *Administrative expenses.* These expenses should be supported by invoices, contracts, agreements, or other written evidence.

h. *General accounting records.* Plans are required to maintain records of their receipts and disbursements; however, in many cases they are prepared by the trustee. General ledgers are also generally maintained by the trustee.

Chapter 2

Accounting and Reporting by Defined Benefit Pension Plans

2.01 FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, establishes generally accepted accounting principles for defined benefit pension plans and prescribes the general form and content of financial statements of those plans.

2.02 This chapter is intended to familiarize the auditor with some of the principal provisions of FASB Statement No. 35, as amended, to provide further discussion of certain principles set forth in the statement and, in the section dealing with terminating plans (paragraphs 2.48 through 2.52), to address an important matter not addressed in the statement. This chapter is not intended to modify or to serve as a substitute for the statement, which should be referred to for the specific accounting requirements for defined benefit pension plans. Appendix C of this guide reproduces the accounting standards of FASB Statement No. 35, as amended, and appendix D contains the illustrative financial statements from the statement.

2.03 Generally accepted accounting principles other than those discussed in this chapter may also apply to defined benefit pension plans.

Exhibit 2-1

QUICK REFERENCE FOR DEFINED BENEFIT PENSION PLANS

This guide has been organized so that the accounting and reporting guidance for defined benefit pension plans is contained in this chapter. Auditing guidance for defined benefit, defined contribution, and health and welfare benefit plans is contained throughout the guide. The following table has been developed to help you locate the areas in this guide that may pertain to an audit of a defined benefit pension plan. Not every area listed will be applicable to a particular client and the nature, timing, and extent of auditing procedures are matters of professional judgment.

Chapter 2	*Accounting and Reporting by Defined Benefit Pension Plans*
Chapter 5	*Planning*
Chapter 6	*Internal Control*
Chapter 7	*Auditing Investments*
Chapter 8	*Auditing Contributions Received and Related Receivables*
Chapter 9	*Auditing Benefit Payments*
Chapter 10	*Auditing Participant Data and Plan Obligations,* specifically 10.10, 10.11, and 10.18–10.26
Chapter 11	*Party in Interest Transactions*
Chapter 12	*Other Auditing Considerations*
Chapter 13	*The Auditor's Reports,* in particular
	13.03–13.05 Standard reports for defined benefit plans
	13.09–13.43 Various other reporting situations that may apply
Appendix A	*ERISA and Related Regulations*
Appendix B	*Examples of Controls*
Appendix C	*Excerpt From FASB Statement No. 35,* Accounting and Reporting by Defined Benefit Pension Plans
Appendix D	*Illustration of Financial Statements: Defined Benefit Pension Plans*
Appendix G	*Summary of Objectives, Procedures, and Other Considerations for Auditing Investments*

Cash Balance Plans

2.04 Traditional defined benefit pension plans provide benefits that are defined in terms of a percentage of final average compensation or career average compensation, or as a flat dollar benefit per year of service. Recently, new types of benefit formulas have become more popular, including—

a. ***Cash Balance Plans.*** A cash balance plan is a special form of career average compensation plan. Typically, a cash balance defined benefit pension plan maintains hypothetical "accounts" for participants. The employer credits participants' "accounts" with a certain number of dollars each plan year, and promises earnings at a specified rate. Interest on the "account" balance is credited at a stated rate, which may be different from the plan's actual rate of investment return. The interest rate may be modified prospectively, so long as there are no reductions in the participant's benefit accrued to date. The formula for determining the amount to be credited to participants' "accounts" can be varied from year to year, if the employer properly amends the plan prior to the beginning of the year and complies with notice requirements under ERISA. A change in interest rate would also require a plan amendment and compliance with notice requirements under ERISA. The principal advantage to participants of a cash balance plan is the ability to watch their hypothetical "account balances" grow (similar to a defined contribution pension plan) while providing certainty as to the interest to be credited. The participants bear no investment risk. The employer bears the risk that the plan's actual rate of return may fall below the stated rate of interest to be credited to participants' accounts. Additionally, if a vested participant switches careers or retires, the lump sum payment equals the hypothetical "account balance"; in a traditional plan a participant would not be able to compute the lump sum he or she is entitled to.

b. ***Pension Equity Plans.*** A pension equity plan is a defined benefit pension plan that has many of the advantages of the cash balance plan, but the benefit formula is similar to a final pay program rather than a career average cash balance program. Under this arrangement, a participant is credited with "points" based on age, service or both. On termination of employment, a participant's final average compensation is multiplied by his or her accumulated points to determine a hypothetical account balance. This balance normally may be distributed as a lump sum or converted to an annuity.

Regulatory Reporting Requirements

2.05 In addition to the reporting requirements of FASB Statement No. 35, as amended, defined benefit pension plans have reporting requirements under ERISA. The financial statements required by ERISA are a statement of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed-income obligations due in default or uncollectible, leases in default or uncollectible, and reportable transactions. The ERISA reporting requirements are described in appendix A.

2.06 In accordance with the requirements of ERISA sections 105 and 209, the plan administrator must furnish to any participant who so requests in writing—but not more than once a year—a statement of the participant's total accrued benefit and the earliest date on which he or she will become vested.

Financial Statements

2.07 The FASB has determined that the primary objective of a plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. That objective requires the presentation of information about the plan's economic resources and a measure of participants' accumulated benefits.

2.08 Unless the financial statements are not intended to be presented in accordance with generally accepted accounting principles, the financial statements of a defined benefit pension plan should be prepared on the accrual basis and should include the following:[2]

a. A statement of the net assets available for benefits as of the end of the plan year[3]

b. A statement of changes in net assets available for benefits for the year then ended

c. Information regarding the actuarial present value of accumulated plan benefits

d. Information regarding the effects, if significant, of certain factors affecting the year-to-year change in accumulated plan benefits

2.09 FASB Statement No. 35, as amended, gives guidance on the form and content of the required financial statements and specifies that they be presented in sufficient detail to assist readers of plan financial statements in assessing the plan's present and future ability to pay benefits when due. Information regarding the actuarial present value of accumulated plan benefits and changes therein, however, may be presented in the financial statements or in the notes.

Net Assets Available for Benefits

Investments

2.10 Plan investments are generally to be presented at their fair value at the reporting date (see paragraph 2.13 for special provisions concerning the valuation of insurance contracts). Fair value of plan investments is the amount that the plan could reasonably expect to receive in a current sale of assets and should be measured by quoted market prices when available. Original cost of investments is not required to be disclosed. (The accounting for assets used in the administration of the plan is discussed in paragraph 2.17.)

2.11 Some plan investments may not have market quotations and, therefore, will need to be valued "in good faith." Examples include real estate, mortgages or other loans, restricted securities, unregistered securities, and securities for which the market is thin. It is the obligation of the plan's trustees, the administrator, and the corporate trustee (*a*) to satisfy themselves that all appropriate factors relevant to the value of the investments have been considered and (*b*) to select a method to estimate the fair value of the investments.

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[2] FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Acquired for Resale* (an amendment of FASB Statement No. 95, *Statement of Cash Flows*), excluded defined benefit pension plans that present information in accordance with the provisions of FASB Statement No. 35, as amended, from the requirement of FASB Statement No. 95 to present a statement of cash flows. Plans should consider providing a statement of cash flows when that statement would provide relevant information about the ability of the plan to pay benefits (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

[3] ERISA requires that this statement be presented in comparative form.

To the extent considered necessary, the plan may use the services of a specialist to estimate the fair value of investments valued in good faith.

2.12 Some of the general factors that may be considered in estimating the fair value of plan investments are the type of investment, cost at date of purchase, size and period of holdings, information about transactions or offers regarding the investment, reported prices and extent of trading in similar investments, a forecast of expected cash flows from the investment, changes in economic conditions relating to the investment, financial condition of the investee or issuer, current interest rates, and the nature and duration of restrictions on disposition. The foregoing is not a complete list of all factors that may be considered.

2.13 A defined benefit plan should report investment contracts at fair value. See FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*. Whether or not the plan is subject to ERISA, insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by a plan with certain governmental agencies pursuant to ERISA, consistent with the requirements of DOL Form 5500 or 5500-C/R. The current Form 5500 (1992) permits unallocated insurance contracts to be reported at either current value or as determined on the Schedule A, *Insurance Information*, that is, contract value. This is an exception to the general requirement of FASB Statement No. 35, as amended, that plan investments be presented at fair value. A plan not subject to ERISA should present its insurance contracts as if the plan were subject to the reporting requirements of ERISA.

2.14 Presentation of plan investments in the statement of net assets available for benefits should be detailed by general type such as government securities, short-term securities, corporate bonds, common stocks, mortgages, and real estate. Also reflected as individual line items in the financial statements are investments in bank common and commingled trust funds and master trusts and investments in contracts with insurance companies, including separate accounts, deposit administration (DA), and immediate participation guarantee (IPG) contracts. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were otherwise determined.

Contributions

2.15 Contributions receivable are amounts due as of the date of the financial statements, including legal or contractual obligations and, for a single employer plan, obligations resulting from a formal commitment. Evidence of a formal commitment may include (*a*) a formal resolution by the sponsor, (*b*) amounts relating to an established funding policy, (*c*) a deduction on the federal tax return, or (*d*) the employer's recognition, as of the reporting date, of a contribution payable to the plan.[4] Contributions receivable should include an allowance for estimated uncollectible amounts.

2.16 A multiemployer plan may also have a receivable for a withdrawing employer's share of the plan's unfunded liability. The plan should record the receivable, net of any allowance for an amount deemed uncollectible, when entitlement has been determined.

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[4] The existence of accrued costs in the employer's financial statements or a deficit in net assets of the plan do not, by themselves, provide sufficient support for recognition of a contribution receivable by the plan.

Operating Assets

2.17 Assets used in the administration of the plan (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) are to be stated at cost less accumulated depreciation or amortization.

2.18 FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, establishes accounting standards for the impairment of long-lived assets for assets to be held and used and assets to be disposed of. The standard requires that long-lived assets to be held and used by the plan, such as real estate owned by the plan for plan operations, be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement No. 121 also requires long-lived assets the plan expects to dispose of to be reported at the lower of its carrying amount or fair value less cost to sell. Assets to be disposed of should not be depreciated while they are held for disposal. See FASB Statement No. 121 for further accounting and disclosure requirements.

Accrued Liabilities

2.19 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits. Benefit amounts should not be accrued as liabilities.

Changes in Net Assets Available for Benefits

2.20 Information regarding changes in net assets available for benefits is intended to present the effects of significant changes in net assets during the year and should present, at a minimum—

a. The net change in the fair value (or estimated fair value) of each significant type of investment (see paragraph 2.14). Gains and losses from investments sold need not be segregated from unrealized gains and losses relating to investments held at year-end.

b. Investment income, exclusive of changes in fair value described in (*a*) preceding.

c. Contributions from employers.

d. Contributions from participants.

e. Contributions from other sources.

f. Benefits paid.

g. Payments to insurance companies to purchase contracts that are excluded from plan assets.

h. Administrative expenses.

Other changes (for example, transfers of assets to or from other plans) should also be presented if they are significant.

Accumulated Plan Benefits

2.21 Accumulated plan benefits are to be presented as the present value of future benefits attributable, under the plan's provisions, to service rendered to the date of the actuarial valuation. The accumulated benefit information may be presented as of the beginning or the end of the plan year; under FASB Statement No. 35, as amended, however, an end-of-year benefit information date is considered preferable. If the information is as of the beginning of the year, prior-year statements of net assets and changes therein are also required; otherwise, comparative statements are not required.

2.22 Accumulated plan benefits include benefits for (*a*) retired or terminated employees or their beneficiaries, (*b*) beneficiaries of deceased employees, and (*c*) present employees or their beneficiaries. To the extent possible, plan provisions should govern the measurement of accumulated plan benefits. When the plan does not specify the benefits earned in each year, a general method for measurement is provided in FASB Statement No. 35, paragraph 17. Future service should be considered only in determining an employee's eligibility for certain benefits. Future increases in salaries and benefits are assumed only to the extent that they have been specified (for example, automatic cost-of-living increases). Plans providing death and disability benefits should consider these factors in the calculation. Retroactive plan amendments adopted before the date of the calculation should be given effect in the calculation, even if some provisions take effect only in future periods. Plan amendments occurring after the date of the calculation should be excluded. As in the presentation of plan assets, benefits that are guaranteed by a contract with an insurance company, that is, *allocated contracts*, should be excluded.

2.23 The assumptions used in calculating accumulated plan benefits are to be based on the premise of an ongoing plan. Accordingly, the interest rates used for discounting expected future payments should reflect the rates of return expected on plan investments during the periods for which the benefits are deferred (see paragraph 20 of FASB Statement No. 35). An appropriate allowance for future employee mortality and turnover should be provided. The significant assumptions used in the calculation must be developed using an *explicit* approach, whereby each assumption, standing alone, represents the best estimate of the plan's future experience. These assumptions may differ from those used in the determination of the plan's funding and the plan sponsor's pension costs.

2.24 As noted previously, the benefit information may be presented in a separate statement, combined with other information in a financial statement, or presented in a note to the financial statements. The information, however, must all be located in one place and should be classified as follows:

a. Vested benefits of participants currently receiving benefits

b. Other vested benefits

c. Nonvested benefits

If the plan is contributory, accumulated contributions of active employees including, if applicable, interest credited on those contributions, should be disclosed. If interest is credited on the contributions, the interest rate should also be disclosed.

Changes in Accumulated Plan Benefits

2.25 Information regarding the change in accumulated benefits from the beginning to the end of the year should be presented to identify significant factors affecting the comparability of the year-to-year accumulated benefits. As with the accumulated benefit information, the changes may be presented in the body of the financial statements or in the notes; they may be presented in either a reconciliation or a narrative format. Minimum disclosures should include the significant effects of such factors as plan amendments, changes in the nature of the plan, and changes in actuarial assumptions. Changes in actuarial assumptions are to be viewed as changes in accounting estimates, and, therefore, previously reported amounts should not be restated. If only the minimum required disclosure is presented, presentation in a statement format will necessitate an additional unidentified other category to reconcile the beginning and ending amounts.

Additional Financial Statement Disclosures

2.26 APB Opinion No. 22, *Disclosure of Accounting Policies*, requires the disclosure of significant accounting policies, and FASB Statement No. 35, as amended, requires disclosure of (*a*) the method and significant assumptions used to value investments and contracts with insurance companies and (*b*) the method and significant assumptions used in determining the actuarial present value of accumulated plan benefits, including any significant changes in the method or assumptions during the year.

2.27 FASB Statement No. 35, as amended, also requires disclosure of—

a. A brief general description of the plan agreement, including its vesting and benefit provisions.

b. A description of significant plan amendments adopted during the year. If the amendments were adopted after the date of the accumulated benefit information, and accordingly their effect was not included in the calculation, this fact should be stated.

c. A brief description of the benefit priority and PBGC coverage in the event of plan termination.

d. The funding policy and any changes in the policy during the year. When applicable, the method of determining employee contributions should be disclosed. ERISA plans should disclose their status with respect to any applicable minimum funding requirements.

e. The policy regarding the purchase of insurance contracts that have been excluded from plan assets and the income from those contracts for the year.

f. The federal income tax status of the plan if a favorable determination letter from the IRS has not been obtained or maintained. Note that reports filed in accordance with the requirements of ERISA must include disclosure of "information concerning whether or not a tax ruling or determination letter has been obtained," which is more than is required by FASB Statement No. 35, as amended.

g. Investments that represent 5 percent or more of total net assets. (Listing all investments in the schedule of Assets Held for Investment Purposes required by ERISA does not eliminate the requirement to include this disclosure in the financial statements.)

h. Significant related-party transactions (see appendix A and chapter 11 for a discussion of related-party transactions).

i. Significant subsequent events that may affect the usefulness of the financial statements (see chapter 12 for a discussion of subsequent events).

This list is not intended to modify the disclosure requirements of FASB Statement No. 35, as amended, but, rather, to serve as a reference to the major requirements. Nor does this list include information required by ERISA to be disclosed in the schedules filed as part of a plan's annual report. In this connection, it is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information on the face of the financial statements or in the notes to the financial statements but not in the schedules is not acceptable.

2.28 FASB Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,* requires all entities to disclose information principally about financial instruments with off-balance-sheet risk. Financial instruments of a pension plan, other than obligations for pension benefits, when subject to the accounting and reporting requirements of FASB Statement No. 35, as amended, are included in the scope of FASB Statement No. 105, as amended. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87, *Employers' Accounting for Pensions;* (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments;* and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations.*

2.29 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of this statement are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, futures contracts, and interest rate and foreign currency swaps.

2.30 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments:

With Off-Balance-Sheet Risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)

- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion No. 22

With Off-Balance-Sheet Credit Risk:

- The amount of the accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

2.31 FASB Statement No. 105,* as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

2.32 As indicated in paragraph 2.14 investments in master trusts are presented in a single line item in the statement of net assets available for benefits. In the notes to the financial statements the investments of the master trust should be detailed by general type, such as government securities, short-term securities, corporate bonds, common stocks, mortgages and real estate, as of the date of each statement of net assets available for benefits presented. The net change in the fair value of each significant type of investment of the master trust and total investment income of the master trust by type, e.g., interest, dividends, etc., should also be disclosed in the notes for each period for which a statement of changes in net assets available for benefits is presented. The notes to the financial statements should also include a description of the basis used to allocate net assets, net investment income, gains and losses to participating plans, and the plan's percentage interest in the master trust as of the date of each statement of net assets available for benefits presented.

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* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

2.33 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*,* as amended by FASB Statements No. 119* and No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, requires all entities except for those covered by the exemption in FASB Statement No. 126,** for which the disclosure is optional, to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a pension plan other than (i) obligations for pension benefits as defined in FASB Statement No. 35, as amended, and (ii) insurance contracts as defined in FASB Statement No. 110 are included in the scope of FASB Statement No. 107, as amended, and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

2.34 FASB Statement No. 107,* as amended, requires entities except for those covered by the exemption in FASB Statement No. 126,** for which the disclosure is optional, to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading.*** An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

2.35 FASB Statement No. 119* requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105* and No. 107.

2.36 FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

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* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

** FASB Statement No. 126 amends FASB Statement No. 107 to make the disclosures prescribed in FASB Statement No. 107 optional for plans that meet all of the following criteria:

a. The plan is a nonpublic entity.

b. The plan's total assets are less than $100 million on the date of the financial statements.

c. The plan has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, other than loan commitments, during the reporting period.

Note that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, replaces paragraph 2(c) of FASB Statement No. 126 (item *c.* above) with the following:

> The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

See the Preface of this guide for a discussion of FASB Statement No. 133.

*** This sentence is deleted by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. See the Preface of this guide for a discussion of FASB Statement No. 133.

2.37 *401(h) Accounts.*[*] Some defined benefit pension plans provide a postretirement medical-benefit component in addition to the normal retirement benefits of the plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Employers may fund a portion of their postretirement medical-benefit obligations related to their health and welfare benefit plans through a health benefit account (401(h) account) in their defined benefit pension plans, subject to certain restrictions and limitations. Funding can be accomplished through a qualified transfer of excess pension plan assets or through additional contributions. Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) must be used only to pay qualified current retiree health benefits for the taxable year of the transfer (whether directly or through reimbursement). Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used in the year must be transferred out of the account to the pension plan.

2.38 The IRC allows employers to allocate up to 25 percent of total contributions to the plan, subject to certain limitations, to the 401(h) account. If the full amount of these contributions is not used during the year, they may be accumulated for future retiree medical expenses in the 401(h) account. The deductibility of employer contributions to a 401(h) account is subject to separate limitations and, therefore, such contributions have no effect on the amount of deductible contributions an employer can make to fund pension benefits under the plan. The earnings on the 401(h) account are ignored for minimum funding purposes. Additionally, under the IRC, qualified transfers are not treated as prohibited transactions for purposes of Section 4975.

2.39 The plan sponsor has discretion in making contributions to the 401(h) account. A pension or annuity plan may provide for payment of medical benefits for retired employees, their spouses, and their dependents if all of the following conditions are met.

a. Benefits are subordinate (as defined in Section 401(h) of the IRC) to the retirement benefits provided by the plan.

b. A separate account is established and maintained for such benefits.

c. The employer's contributions to the separate account are reasonable and ascertainable.

d. It is impossible, at any time prior to the satisfaction of all obligations under the plan to provide such benefits, for any part of the corpus or income of the separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits.

e. Notwithstanding the provisions of certain IRC sections, upon satisfaction of all obligations under the plan to provide such benefits, any amount remaining in the separate account must, under the terms of the plan, be returned to the employer.

f. In the case of an employee who is a key employee (as defined in Section 416(i)), a separate account is established and maintained for

[*] The guidance contained in paragraphs 2.37 through 2.43 is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged. See paragraph 20 of the SOP [appendix K of this guide] for transition guidance upon adoption.

such benefits which are payable to such employee (and the spouse and dependents), and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are payable only to that employee (and the spouse and dependents) from the separate account.

2.40 The 401(h) assets may be used only to pay current retiree health benefits, which generally are obligations of a separate health and welfare benefit plan or health benefit arrangement. They may not be used to satisfy pension obligations. Although the assets may be invested together with assets that are available to pay pension benefits, a separate accounting must be maintained for all qualified transfers, contributions, distributions and/or expenses, and income earned thereon.

2.41 Because the 401(h) net assets may not be used to satisfy pension obligations, the total of net assets available for pension benefits must not include net assets held in the 401(h) account related to obligations of the health and welfare benefit plan. The 401(h) account assets less liabilities (net assets of the 401(h) account) are required to be shown in defined benefit pension plan financial statements as a single line item on the face of the statements (as illustrated in appendix B of SOP 99-2). Those net assets related to the 401(h) account also must be deducted before arriving at the total of net assets available for pension benefits. In deducting those net assets, the amount related to the 401(h) features should be presented as a separate line item in the liabilities section of the statement of net assets available for pension benefits. The financial statement caption should clearly denote that the net assets held in the 401(h) account relate to obligations of the health and welfare benefit plan or arrangement. The statement of changes in net assets should show only the changes in net assets of the pension plan and not any of the components of the changes in the net assets in the 401(h) account. The only amounts that should be reported in the statement of changes in net assets are qualified transfers to the 401(h) account and/or any unused or unspent amounts (including allocated income) in the 401(h) account at the end of the year that were qualified transfers of excess pension plan assets that should have been, but were not, transferred back to the defined benefit pension plan.

2.42 Information regarding accumulated plan benefits should relate only to pension obligations. Even in situations in which separate financial statements are not prepared for the health and welfare benefit plan, obligations related to retiree health benefits should not be reported in the statement of accumulated plan benefits of the defined benefit pension plan financial statements.

2.43 Defined benefit pension plans should disclose in the notes to the financial statements the fact that the 401(h) account assets are available only to pay retiree health benefits.

Risks and Uncertainties

2.44 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires plans to include in their financial statements disclosures about (*a*) the nature of their operations, and (*b*) use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires plans to include in their financial statements disclosures about (*a*) certain significant estimates, and (*b*) current vulnerability due to certain concentrations.

2.45 Certain significant estimates should be disclosed when known information available prior to issuance of the financial statements indicates that (*a*) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events, and (*b*) the effect of the change would be material to the financial statements. For example, the present value of accumulated plan benefits could be subject to a material change when—

- Employees covered by the plan work in an industry that experienced a significant economic downturn in the previous year and it is reasonably possible that in the subsequent period a significant number of employees will retire early without a monetary incentive to do so in order to avoid being laid-off with nominal benefits. This could significantly increase the present value of accumulated plan benefits and possibly cause the plan to be underfunded.
- Employees covered by the plan are party to a collective bargaining agreement which was up for renegotiation at year-end and it is reasonably possible that management's offer to significantly increase pension benefits in lieu of granting the union's request for a significant increase in cash compensation will be accepted within the next year. This could significantly increase the present value of accumulated plan benefits.
- Prior to year-end the employer announced a planned downsizing but had not decided on the number of employees to be terminated, and it is reasonably possible that when the decision is made during the next year, it will result in employees receiving pension benefits earlier than expected and in an amount greater than originally projected.
- It is reasonably possible that there will be a significant decline in the fair value of investments (i.e., financial instruments) during the next year which would change the assumed rates of return used to discount the benefit obligation and therefore could significantly affect the present value of accumulated plan benefits.

2.46 Vulnerability from concentrations arises when a plan is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Many plan's participants may be concentrated in a specific industry that carries with it certain risks. Plans may also hold investments and other assets (other than financial instruments for which concentrations are covered by FASB Statement No. 105* rather than SOP 94-6) that are concentrated in a single industry or in a single geographic area. Concentrations should be disclosed if based on known information prior to issuance of the financial statements (*a*) the concentration exits at the date of the financial statements, (*b*) the concentration makes the plan vulnerable to the risk of a near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. For example, if the plan owns several investment properties (i.e., apartment buildings) located in a geographic area that has only one significant employer and that employer announced last year that it is considering leaving the area and it is reasonably possible that it will do so within the next year, this could significantly affect the plan's future cash flows from rents and the value of the investment properties.

2.47 Since the disclosure requirements of SOP 94-6 in many circumstances are similar to or overlap the disclosure requirements in certain FASB

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* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

pronouncements (for example, FASB Statements No. 5, *Accounting for Contingencies*, and No. 105*), the disclosures required by SOP 94-6 may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

Terminating Plans

2.48 FASB Statement No. 35, as amended, explicitly excludes terminating plans. For purposes of this guide, terminating plans include all plans as to which a decision to terminate has been made, regardless of whether the terminated plan will be replaced.

2.49 When the decision to terminate a plan has been made,[5] or a wasting trust or frozen plan (that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits) exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan.

2.50 If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, described subsequently. If the decision is made after the year-end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, section 560, *Subsequent Events*, paragraph 5.

2.51 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis. An Auditing Standards Division staff interpretation, *Reporting on Financial Statements Prepared on a Liquidation Basis of Accpunting* (AICPA, *Professional Standards*, vol. 1, AU section 9508.33–.38), contains applicable guidance as to the auditor's reporting responsibilities with respect to terminating plans. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance contracts carried at *contract values*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices.

2.52 Accumulated plan benefits should be determined on a liquidation basis, which may differ significantly from the actuarial present value of accumulated plan benefits reported for an ongoing plan. In general, upon termination all benefits should be reported as vested.

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* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

[5] Refer to paragraph 12.18, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent written representation as to whether there is a present intention to terminate the plan. Refer also to paragraph 10.33*h*, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

Chapter 3

Accounting and Reporting by Defined Contribution Plans

3.01 This chapter describes generally accepted accounting principles for accounting and financial reporting that are particularly important to defined contribution plans. Other generally accepted accounting principles may also apply. Except for differences in determining plan benefits, as noted in paragraph 3.03, defined contribution plans are similar to defined benefit plans. Accordingly, the guidance in this chapter is consistent with the accounting and reporting standards in FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended, and chapter 2 of this guide to the extent that this is appropriate.

Exhibit 3-1

QUICK REFERENCE FOR DEFINED CONTRIBUTION PENSION PLANS

This guide has been organized so that the accounting and reporting guidance for defined contribution pension plans is contained in this chapter. Auditing guidance for defined benefit, defined contribution, and health and welfare benefit plans is contained throughout the guide. The following table has been developed to help you locate the areas in this guide that may pertain to an audit of a defined contribution pension plan. Not every area listed will be applicable to a particular client and the nature, timing, and extent of auditing procedures are matters of professional judgment.

Chapter 3	*Accounting and Reporting by Defined Contribution Plans*	
Chapter 5	*Planning*	
Chapter 6	*Internal Control*	
Chapter 7	*Auditing Investments*	
Chapter 8	*Auditing Contributions Received and Related Receivables*	
Chapter 9	*Auditing Benefit Payments*	
Chapter 10	*Auditing Participant Data and Plan Obligations,* specifically 10.12–10.14 and 10.27–10.30	
Chapter 11	*Party in Interest Transactions*	
Chapter 12	*Other Auditing Considerations*	
Chapter 13	*The Auditor's Reports,* in particular	
	13.06	Standard reports for defined contribution plans
	13.09–13.38 and 13.39–13.41	Various other reporting situations that may apply
	13.37–13.38	Reporting Separate Investment Fund Information
Appendix A	*ERISA and Related Regulations*	
Appendix B	*Examples of Controls*	
Appendix C	*Excerpt From FASB Statement No. 35,* Accounting and Reporting by Defined Benefit Pension Plans	
Appendix E	*Illustrations of Financial Statements: Defined Contribution Plans*	
Appendix G	*Summary of Objectives, Procedures, and Other Considerations for Auditing Investments*	
Appendix H	*Appendix to Statement of Position 94-4*: Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments	

3.02 Defined contribution plans require an individual account for each participant and provide benefits based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience on such amounts, (*c*) expenses, and (*d*) any forfeitures allocated to the account.

3.03 Under a defined contribution plan the employer contribution rate is generally determined periodically at the discretion of the employer or by contractual agreement, or both. When a participant retires or withdraws from the plan, the amount allocated to the participant's account (if fully vested) represents the participant's accumulated benefits. That amount may be paid to the participant or used to purchase a retirement annuity. The amount of benefits a participant will ultimately receive is generally not determined until the time of payment. By contrast, in a defined benefit plan, benefits are determinable and the contribution necessary to provide those benefits is actuarially determined. In other respects, defined contribution plans are similar to defined benefit plans.

3.04 There are three general types of defined contribution plans: profit-sharing plans, money purchase pension plans, and stock bonus plans.

a. A *profit-sharing plan* is a defined contribution plan that is not a pension plan (as defined in the IRC) or a stock bonus plan. Employer contributions may be discretionary or may be based on a fixed formula related to profits, compensation, or other factors. Before 1987, contributions had to be made from the plan sponsor's current or accumulated profits. This requirement is no longer in effect. A profit-sharing plan must be designated as such in the plan document.

b. A *money purchase pension plan* is a defined contribution plan under which employer contributions are based on a fixed formula that is not related to profits and that is designated as a pension plan by the plan sponsor.

c. A *stock bonus plan* is a defined contribution plan under which distributions are normally made in stock of the employer, unless the distributee elects otherwise.

3.05 A number of more specialized plans exist that are included in the three general types of plans. These include the following:

- A *cash-or-deferred arrangement* (also called a *section 401(k) plan*) may be incorporated into a profit-sharing or stock bonus plan (a few pre-ERISA money purchase pension plans also incorporate cash-or-deferred arrangements). Under such an arrangement, a participant is permitted to elect to receive amounts in cash or have them contributed to the plan as employer contributions on the participant's behalf.
- A *thrift plan* (also called a *savings plan*) is a profit-sharing or stock bonus plan under which participants make after-tax employee contributions that are usually matched, in whole or in part, by employer contributions.
- An *employee stock ownership plan* (an *ESOP*) is a stock bonus plan that may borrow money from, or on the guarantee of, a related party (a *party in interest* as defined in section 3(14) of ERISA) for the purpose of acquiring securities issued by the plan sponsor and that invests primarily in such securities (a *leveraged ESOP*). The term *employee stock ownership plan* is also generally applied to (*a*) nonleveraged stock bonus plans that satisfy various requirements set forth in section 4975(e)(7) of the IRC and (*b*) profit-sharing plans (and certain pre-ERISA money purchase pension plans) that invest primarily in securities issued by the plan sponsor (see illustrated ESOP financial statements in appendix E).

- A *tax credit employee stock ownership plan* is a profit-sharing or stock bonus plan established before 1987 that satisfies the requirements of section 409 of the IRC. The sponsor of such a plan is allowed a tax credit, rather than a deduction, for its contributions. Before 1982 these plans were commonly known as TRASOPs (for Tax Reduction Act Stock Ownership Plan), and the maximum allowable credit was based on the plan sponsor's investments that qualified for the investment tax credit. In 1982 TRASOPs were succeeded by PAYSOPs, under which the credit was based on the plan sponsor's payroll.
- A *target benefit plan* is a form of money purchase pension plan under which the employer's annual contribution on behalf of each participant is the actuarially determined amount required to fund a *target benefit* established by a plan formula. The target benefit is usually based on compensation and length of service. For some target benefit plans, the substance of the plan may be to provide a defined benefit. For such plans, accounting and reporting as defined benefit plans, as discussed in chapter 2 of this guide, may be more appropriate.
- A *Keogh plan* (also called an *HR 10 plan*) is any defined benefit or defined contribution plan that covers one or more self-employed individuals.

Regulatory Reporting Requirements

3.06 ERISA established annual reporting requirements for employee benefit plans, including defined contribution plans. Those requirements, including financial statement and schedule requirements, are described in appendix A. The financial statements required by ERISA are a statement of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed income obligations due in default or uncollectible, leases in default or uncollectible, and reportable transactions.

3.07 Some defined contribution plans are required to register and report to the Securities and Exchange Commission (SEC). Regulation S-X prescribes the form of the statements of financial position and statements of income and changes in plan equity that those plans must file with the SEC. The SEC has amended its rules for Form 11-K to permit plans subject to ERISA to file financial statements in accordance with ERISA rather than in accordance with Regulation S-X.

3.08 In accordance with the requirements of ERISA sections 105 and 209, the plan administrator must furnish to any participant who so requests in writing—but not more than once a year—a statement of the participant's total vested and nonvested accrued benefits.

Financial Statements

3.09 The primary objective of a defined contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and how the stewardship responsibility for those resources has been discharged, (*b*) the results of transactions and events that affect the information about those resources, and (*c*) other factors necessary for users to understand the information provided.[6]

3.10 Unless the financial statements are not intended to be presented in accordance with generally accepted accounting principles, the financial statements of a defined contribution plan should be prepared on the accrual basis of accounting[7] and should include (*a*) a statement of net assets available for benefits as of the end of the plan year[8] and (*b*) a statement of changes in net assets available for benefits for the year then ended.

3.11 Appendix E provides illustrative financial statements for a defined contribution plan. The information should be presented in sufficient detail to assist readers of plan financial statements in assessing the plan's present and future ability to pay benefits.

Net Assets Available for Benefits

Investments

3.12 Plan investments are generally to be presented at their fair value at the reporting date (see paragraph 3.14 for special provisions concerning the valuation of insurance contracts and paragraph 3.17 for special provisions concerning the valuation of fully benefit-responsive investment-contracts). Fair value of plan investments is the amount that the plan could reasonably expect to receive in a current sale of assets and should be measured by quoted market prices when available. Original cost of investments is not required to be disclosed.

3.13 According to SOP 94-4, insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

3.14 Some plan investments may not have market quotations and, therefore, will need to be valued "in good faith." Examples include real estate, mortgages, or other loans (including loans to participants of a 401(k) plan),

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[6] In a defined contribution plan, the plan's net assets available to pay benefits equals the sum of participants' individual account balances. Accordingly, the plan's ability to pay benefits relates to the plan's ability to pay individual participants the then current value of their account balances when due. It should be recognized that (*a*) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (*b*) financial statements for several plan years can provide more useful information for assessing the plan's future ability to pay benefits than can financial statements for a single plan year.

FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Acquired for Resale*, exempts certain benefit plans from the requirement to provide a statement of cash flows. Plans should consider providing a statement of cash flows when that statement would provide relevant information about the ability of the plan to pay benefits (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

[7] The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and *(a)* the fair value of the securities purchased or sold immediately before the financial statement date does not change significantly from the trade date to the financial statement date and *(b)* the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[8] ERISA requires that this statement be presented in comparative form.

restricted securities, unregistered securities, securities for which the market is thin, and nontransferable investment contracts. It is the obligation of the plan's trustees, the administrator, and the corporate trustee (*a*) to satisfy themselves that all appropriate factors relevant to the value of the investments have been considered and (*b*) to select a method to estimate the fair value of the investments. To the extent considered necessary, the plan may use the services of a specialist to estimate the fair value of investments valued in good faith.

3.15 Some of the general factors that may be considered in estimating the fair value of plan investments are the type of investment, cost at date of purchase, size and period of holdings, information about transactions or offers regarding the investment, reported prices and extent of trading in similar investments, a forecast of expected cash flows from the investment, changes in economic conditions relating to the investment, financial condition of the investee or issuer, current interest rates, and the nature and duration of restrictions on disposition. The foregoing is not a complete list of all factors that may be considered.

3.16 Defined-contribution pension plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

3.17 Plan assets of defined-contribution pension plans should be measured and reported at values that are meaningful to financial statement users, including plan participants. The contract value of a fully benefit-responsive investment contract held by a plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution pension plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, disclosure of the event or reporting the investment at less than contract value may be appropriate.

3.18 Benefit responsiveness is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of the contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-income investment options to limit arbitrage among those investment options (equity wash provisions) would not affect a contract's benefit responsiveness.

3.19 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

3.20 Participant-directed plan investments may be shown in the aggregate, as a one-line item, in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investment companies (also known as mutual funds), government securities, short-term securities, corporate bonds, common stocks, mortgages, loans to participants, and real estate. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise.

Contributions Receivable

3.21 Contributions receivable are the amounts due, as of the financial statement date, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants, which should be separately identified). Contributions receivable include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution, (*b*) a consistent pattern of making payments after the plan's year-end pursuant to an established contribution policy that attributes such subsequent payments to the preceding plan year, (*c*) a deduction of a contribution for federal tax purposes for periods ending on or before the financial statement date, or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[9] Contributions receivable should include an allowance for estimated uncollectible amounts.

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[9] The existence of an accrued contribution payable in the employer's financial statements does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

Operating Assets

3.22 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be presented at cost less accumulated depreciation or amortization.

3.23 FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets for assets to be held and used and assets to be disposed of. The standard requires that long-lived assets to be held and used by the plan, such as real estate owned by the plan for plan operations, be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement No. 121 also requires long-lived assets the plan expects to dispose of to be reported at the lower of its carrying amount or fair value less cost to sell. Assets to be disposed of should not be depreciated while they are held for disposal. See FASB Statement No. 121 for further accounting and disclosure requirements.

Accrued Liabilities

3.24 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits. The plan should not reflect as liabilities amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid (see paragraph 3.28*l*).

Changes in Net Assets Available for Benefits

3.25 Information regarding changes in net assets available for benefits is intended to present the effects of significant changes in net assets during the year and should present at a minimum—

a. The change in fair value (or estimated fair value) of each significant type of investment (see paragraph 3.20). Gains and losses from investments sold need not be segregated from unrealized gains and losses relating to investments held at year-end.[10]

b. Investment income, exclusive of changes in fair value described in (*a*) preceding.

c. Contributions from employers, segregated between cash and noncash contributions (a noncash contribution should be recorded at fair value; the nature of noncash contributions should be described either parenthetically or in a note).

d. Contributions from participants, including those transmitted by the sponsor.

e. Contributions from other identified sources (for example, state subsidies or federal grants).

f. Benefits paid to participants.

g. Payments to insurance companies to purchase contracts that are excluded from plan assets.

h. Administrative expenses.

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[10] Realized gains and losses on investments that were both bought and sold during the period should be included.

3.26 The minimum disclosures should be made to the extent that they apply to the plan. The list of minimum disclosures is not intended to limit the amount of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful. Other changes (for example, transfers of assets to or from other plans) should also be presented if they are significant.

Additional Financial Statement Disclosures

3.27 Disclosure of the plan's accounting policies should include a description of the methods and significant assumptions used to determine the fair value of investments and the reported value of insurance contracts (if any).[11]

3.28 The financial statements should also disclose, if applicable—

a. A brief, general description of the plan agreement including, but not limited to, vesting and allocation provisions and the disposition of forfeitures. If a plan agreement or a description providing this information is otherwise published and made available, this description may be omitted from the financial statement provided that reference to the other source is made.

b. A description of significant plan amendments adopted during the period, and the effects of such amendments on net assets if significant either individually or in the aggregate.

c. The amount of unallocated assets, as well as the basis used to allocate asset values to participants' accounts when that basis differs from the one used to record assets in the financial statements.

d. The basis for determining contributions by employers and, for a contributory plan, the method of determining participants' contributions.[12] Plans subject to the minimum funding requirements of ERISA, such as money purchase pension plans, should disclose whether those requirements have been met. If a minimum funding waiver has been granted by the IRS, or if a request for waiver is pending before the IRS, that fact should be disclosed.

e. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets.

f. The federal income tax status of the plan if a favorable determination letter has not been obtained or maintained. Note that reports filed in accordance with the requirements of ERISA must include disclosure of "information concerning whether a tax ruling or determination letter has been obtained," which is more than is required by FASB Statement No. 35, as amended.

g. Identification of investments that represent 5 percent or more of the net assets available for benefits. If any of those investments are nonparticipant-directed, they should be identified as such. (Listing all investments in the schedule of Assets Held for Investment Purposes required by ERISA does not eliminate the requirement to include this disclosure in the financial statements.)

h. Significant related-party transactions (see appendix A and chapter 11 for a discussion of related-party transactions).

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[11] See APB Opinion No. 22, *Disclosure of Accounting Policies*.

[12] If significant costs of plan administration are being absorbed by the employers, that fact should be disclosed.

i. Investments pledged to secure debt of the plan as well as a description of the provisions regarding the release of such investments from the pledge and the amounts of investments released from the pledge in the last period.

j. Guarantees by others of debt of the plan.

k. If a defined contribution plan provides for participant-directed and nonparticipant-directed investment programs, the plan should disclose information in the financial statements about the net assets and significant components of the changes in net assets relating to the nonparticipant-directed program with such reasonable detail, either in the financial statements or accompanying notes, as is necessary to identify the types of investments and changes therein.

A plan provides for participant-directed investment programs if it allows participants to choose among various investment alternatives. The available alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, that provide varying kinds of investments—for example, equity funds and fixed income funds. The participant may select among the various available alternatives and periodically change that selection.

l. Amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid. These amounts should not be reported as a liability on the statement of net assets available for benefits, in financial statements prepared in conformity with generally accepted accounting principles. A footnote to reconcile the audited financial statements to the Form 5500 may be necessary to comply with ERISA (see paragraphs A.50*a* and A.51*c*).

m. Significant subsequent events that may affect the usefulness of the financial statements (see chapter 12 for a discussion of subsequent events).

n. The amount and disposition of forfeited nonvested accounts. Specifically, identification of those amounts that will be used to reduce future employer contributions.

SOP 94-4 requires the following disclosures to be made:

o. For benefit-responsive investment contracts in the aggregate—

- The average yield for each period for which a statement of net assets available for benefits is presented.
- The crediting interest rate as of the date of each statement of net assets available for benefits presented.
- The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor).
- The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107, as amended by FASB Statement No. 126.

p. A general description of the basis and frequency of determining crediting interest rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).

q. For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500, but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

This list does not include information required by ERISA to be disclosed in the schedules filed as part of a plan's annual report. In this connection, it is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information on the face of the financial statements or in the notes to the financial statements but not in the schedules is not acceptable.

3.29 FASB Statement No. 105, as amended by FASB Statement No. 119, requires all entities to disclose information principally about financial instruments with off-balance-sheet risk. Financial instruments of a pension plan, other than obligations for pension benefits, are included in the scope of FASB Statement No. 105, as amended. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87; (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statements No. 60 and No. 97; and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47.

3.30 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of this statement are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, future contracts, and interest rate and foreign currency swaps.

3.31 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments:

With Off-Balance-Sheet Risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion No. 22

With Off-Balance-Sheet Credit Risk:

- The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

3.32 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

3.33 As indicated in paragraph 3.20 investments in master trusts are presented in a single line item in the statement of net assets available for benefits. In the notes to the financial statements the investments of the master trust should be detailed by general type, such as government securities, short-term securities, corporate bonds, common stocks, mortgages and real estate, as of the date of each statement of net assets available for benefits is presented. The net change in the fair value of each significant type of investment of the master trust and total investment income of the master trust by type, e.g., interest, dividends, etc., should also be disclosed in the notes for each period for which a statement of changes in net assets available for benefits is presented. The notes to the financial statements should also include a description of the basis used to allocate net assets, net investment income, gains and losses to participating plans, and the plan's percentage interest in the master trust as of the date of each statement of net assets available for benefits presented.

3.34 FASB Statement No. 107,* as amended by FASB Statements No. 119* and No. 126, requires all entities except for those covered by the exemption in FASB Statement No. 126,** for which the disclosure is optional, to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which

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* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

** FASB Statement No. 126 amends FASB Statement No. 107 to make the disclosures prescribed in FASB Statement No. 107 optional for plans that meet all of the following criteria:

a. The plan is a nonpublic entity.

b. The plan's total assets are less than $100 million on the date of the financial statements.

c. The plan has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, other than loan commitments, during the reporting period.

Note that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, replaces paragraph 2(c) of FASB Statement No. 126 (item *c.* above) with the following:

> The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

See the Preface of this guide for a discussion of FASB Statement No. 133.

it is practicable to estimate fair value. Generally, financial instruments of a defined-contribution pension plan are included in the scope of FASB Statement No. 107, as amended, and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

3.35 FASB Statement No. 107, as amended, requires entities except for those covered by the exemption in FASB Statement No. 126,** for which the disclosure is optional, to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading.* An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

3.36 FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105** and No. 107.**

3.37 FASB Statement No. 119** requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

Risks and Uncertainties

3.38 SOP 94-6 requires plans to include in their financial statements disclosures about (*a*) the nature of their operations, and (*b*) use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires plans to include in their financial statement disclosures about (*a*) certain significant estimates, and (*b*) current vulnerability due to certain concentrations.

3.39 Certain significant estimates should be disclosed when known information available prior to issuance of the financial statements indicates that both (*a*) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events, and (*b*) the effect of the change would be material to the financial statements.

3.40 Vulnerability from concentrations arises when a plan is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Many plan's participants may be concentrated in a specific industry that carries with it certain risks. Plans may also hold investments and

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* This sentence is deleted by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. See the Preface of this guide for a discussion of FASB Statement No. 133.

** See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

other assets (other than financial instruments for which concentrations are covered by FASB Statement No. 105 rather than SOP 94-6) that are concentrated in a single industry or in a single geographic area. Concentrations should be disclosed if based on known information prior to issuance of the financial statements (*a*) the concentration exits at the date of the financial statements, (*b*) the concentration makes the plan vulnerable to the risk of a near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. For example, if the plan owns several investment properties (i.e., apartment buildings) located in a geographic area that has only one significant employer and that employer announced last year that it is considering leaving the area and it is reasonably possible that it will do so within the next year, this could significantly affect the plan's future cash flows from rents and the value of the investment properties.

3.41 Since the disclosure requirements of SOP 94-6 in many circumstances are similar to or overlap the disclosure requirements in certain FASB pronouncements (for example, FASB Statements No. 5 and No. 105), the disclosures required by SOP 94-6 may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

Employee Stock Ownership Plans

3.42 An ESOP is a unique form of defined contribution plan. Under the prohibited transaction statutory exemptions, an ESOP has the ability to borrow money and to concentrate plan investments in *qualifying employer securities*. (See paragraph A.90.) Frequently these securities are not publicly traded. These circumstances can increase the auditor's risk in reporting on an ESOP.

3.43 The following items are unique to ESOPs:

- Typically, the plan has an annual appraisal of the securities performed. (Paragraph 7.12*h* provides audit guidance regarding the testing of the fair value of investments.)
- Leveraged ESOPs will have obligations to a financial institution or a related party lender. (The auditor should consider testing of debt payments, interest accruals, and loan covenants.)
- ESOP documents frequently reflect specific tax code restrictions, such as on the use of dividends. Paragraphs 12.01 through 12.03 discuss general tax compliance procedures.

403(b) Plans or Arrangements

3.44 These are retirement savings arrangements sponsored by certain nonprofit organizations (such as hospitals and private colleges) and public schools. They are defined contribution plans with individual salary deferral limits that are similar, but not identical to, 401(k) programs. Contributions may include employee salary deferrals and/or employer contributions.

3.45 Investments for funding of these arrangements are restricted by law to annuity contracts (403(b)(1) arrangements) or custodial accounts holding shares of regulated investment company stock, commonly known as mutual funds (403(b)(7) arrangements). Certain 403(b) arrangements are required to file a Form 5500 Annual Return/Report, either as a "large plan" or as a "small plan," depending on the number of participants at the beginning of the plan year. Under current ERISA reporting rules, plans exclusively using a tax deferred annuity arrangement under Code section 403(b)(1) or a custodial account for regulated investment company stock under Code section 403(b)(7) need only complete certain line items on the Form 5500 Annual Return/Report and are not required to include financial information or an auditor's report on the financial statements of the plan.

Terminating Plans

3.46 The Auditing Standards Division staff interpretation, *Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting* (AICPA, *Professional Standards*, vol. 1, AU section 9508.33–.38), contains applicable guidance regarding the auditor's reporting responsibilities for terminating plans. For purposes of this discussion, a terminating plan includes all plans about which a termination decision has been made regardless of whether the terminating plan will be replaced.

3.47 When the decision has been made to terminate a plan,[13] or a wasting trust or frozen plan—that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits—exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan.

3.48 If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, described below. If the decision is made after the year-end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, section 560, *Subsequent Events,* paragraph 5.

3.49 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis of accounting. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance contracts carried at *contract values,* or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices.

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[13] See paragraph 12.18, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent, written representation as to whether there is a present intention to terminate the plan. Refer also to paragraph 10.38, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

Chapter 4

Accounting and Reporting by Health and Welfare Benefit Plans

Exhibit 4-1

QUICK REFERENCE FOR HEALTH AND WELFARE BENEFIT PLANS

This guide has been organized so that the accounting and reporting guidance for health and welfare benefit plans is contained in this chapter. Auditing guidance for defined benefit, defined contribution, and health and welfare benefit plans is contained throughout the guide. The following table has been developed to help you locate the areas in this guide that may pertain to an audit of a health and welfare benefit plan. Not every area listed will be applicable to a particular client and the nature, timing, and extent of auditing procedures are matters of professional judgment.

Chapter 4	*Accounting and Reporting by Health and Welfare Benefit Plans*
Chapter 5	*Planning*
Chapter 6	*Internal Control*
Chapter 7	*Auditing Investments*
Chapter 8	*Auditing Contributions Received and Related Receivables*
Chapter 9	*Auditing Benefit Payments*
Chapter 10	*Auditing Participant Data and Plan Obligations,* specifically 10.15, 10.16, and 10.31–10.38
Chapter 11	*Party in Interest Transactions*
Chapter 12	*Other Auditing Considerations*
Chapter 13	*The Auditor's Reports*, in particular 13.07 and 13.08 — Standard reports for health and welfare benefit plans 13.09–13.41 — Various other reporting situations that may apply
Appendix A	*ERISA and Related Regulations*
Appendix B	*Examples of Controls*
Appendix C	*Excerpt From FASB Statement No. 35,* Accounting and Reporting by Defined Benefit Pension Plans
Appendix F	*Illustrations of Financial Statements: Employee Health and Welfare Benefit Plans* (for plans that have adopted SOP 92-6)
Appendix G	*Summary of Objectives, Procedures, and Other Considerations for Auditing Investments*
Appendix H	*Appendix to Statement of Position 94-4*: Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments

Scope

4.01 Health and welfare benefit plans include plans that provide—

a. Medical, dental, visual, psychiatric, or long-term health care; life insurance (offered separately from a pension plan); certain severance benefits; or accidental death or dismemberment benefits.

b. Benefits for unemployment, disability, vacations, or holidays.

c. Other benefits such as apprenticeships, tuition assistance, day care, dependent care, housing subsidies, or legal services.

This chapter applies to both defined-benefit and defined-contribution health and welfare benefit plans (referred to hereafter as *health and welfare benefit plans*).

4.02 Defined-benefit health and welfare plans specify a determinable benefit, which may be in the form of a reimbursement to the covered plan participant or a direct payment to providers or third-party insurers for the cost of specified services. Such plans may also include benefits that are payable as a lump sum, such as death benefits. The level of benefits may be defined or limited based on factors such as age, years of service, and salary. Contributions may be determined by the plan's actuary or be based on actual claims paid or other factors determined by the plan sponsor. Even when a plan is funded pursuant to agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined-benefit health and welfare plan if its substance is to provide a defined benefit.

4.03 Defined-contribution health and welfare plans maintain an individual account for each plan participant. They have terms that specify the means of determining the contributions to participants' accounts, rather than the amount of benefits the participants are to receive. The benefits a plan participant will receive are limited to the amount contributed to the participant's account, investment experience, expenses, and any forfeitures allocated to the participant's account. These plans also include flexible spending arrangements.

4.04 Health and welfare benefit plans generally are subject to certain fiduciary, reporting, and other requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Plans that are unfunded (that is, those whose benefits are paid solely and directly out of the general assets of the employer), are fully insured (through the direct payment of premiums to the insurance company by the employer; see paragraphs 4.12 and 4.13), or are certain combinations thereof (for example, self-funded plans with stop-loss coverage; see paragraph 4.15) may not be required to include financial statements in their ERISA filings (see appendix A). An understanding of the health and welfare benefit plan is needed to determine its accounting and reporting requirements. It is also important to consider the new forms of funding vehicles that are emerging, particularly with respect to postretirement health benefits.

4.05 This chapter describes generally accepted accounting principles (GAAP) that are particularly important to defined-benefit and defined-contribution health and welfare plans. Generally accepted accounting principles other than those discussed in this chapter may also apply. This chapter does not address the preparation of financial statements on a comprehensive basis of accounting other than GAAP; however, the presentation of a plan's benefit obligation information in GAAP-basis financial statements, as required by paragraph 4.18, is consistent with the disclosures required in financial statements prepared on such bases as the cash basis or modified cash basis, as defined by the requirements of financial reporting to the Department of Labor (DOL).

4.06 FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, does not apply to health and welfare benefit plans; however, as set forth in the guide, the methods of valuing plan investments and requirements for financial statement disclosures are the same as those specified in FASB Statement No. 35.

4.07 FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, establishes standards of financial accounting and reporting by employers for health and welfare benefits expected to be provided to a participant during retirement. While FASB Statement No. 106 does not apply to health and welfare benefit plans, this chapter adopts certain of its measurement concepts (see paragraphs 4.48 through 4.53). Terminology used in discussing postretirement benefits in this chapter is intended to follow usage and definitions provided in FASB Statement No. 106.

Background

4.08 Plan participants may be active or terminated employees (including retirees), as well as covered dependents and beneficiaries, of a single employer or group of employers. Employer contributions may be voluntary or required under the terms of a collective bargaining agreement negotiated with one or more labor organizations. Plans may require contributions from employers and participants (contributory plans) or from employers only (noncontributory plans). During periods of unemployment, a noncontributory plan may require contributions by participants to maintain their eligibility for benefits. Benefits may be provided through insurance contracts paid for by the plan (an insured plan), from net assets accumulated in a trust established by the plan (a self-funded plan), or both.

4.09 As noted above, a plan may establish a trust to hold assets to pay all or part of the covered benefits. The assets may be segregated and legally restricted under a trust arrangement (such as a voluntary employees' beneficiary association or a 501(c)(9) trust, a 401(h) account, or other funding vehicles). Generally, if a separate trust exists, financial statements are required under ERISA. A trust always exists for a multiemployer plan. Such trusteed plans with more than 100 participants generally will require an audit. For ERISA filings, the DOL will not accept an accountant's report that covers the assets of more than one plan. For example, where the assets of more than one plan are held in a 501(c)(9) Voluntary Employees' Beneficiary Association (VEBA) trust, separate reports must be prepared for each plan. Some plans may pay only a portion of the plan's benefit payments and other expenses through the VEBA. Plan transactions, including contributions, benefit payments, and expenses whether paid through the VEBA trust or otherwise, should be subject to audit procedures. If the trustee of the VEBA is a bank or trust company, and the trust holds the assets of more than one plan sponsored by a single employer or by a group of companies under common control, it is a master trust subject to the DOL's master trust filing requirements.

4.10 A health and welfare plan may process benefit payments directly or it may retain a third-party administrator (see paragraph 4.16). In either case, a plan that is fully or partially self-funded is obligated for the related benefits (see paragraphs 4.40 through 4.53).

Arrangements With Insurance Companies

4.11 The nature of, and method of accounting for, the assets and benefit obligations of a health and welfare benefit plan may be determined by the arrangement with the insurance company. The insurance company may assume all or a portion of the financial risk (see paragraphs 4.12 through 4.15), or it may provide only administrative services (see paragraph 4.16) or investment management services (see chapter 7). It is important to have an understanding of the insurance arrangement to determine whether any or all of the risks associated with benefit payments or claims have been transferred to the insurance company. Also, other arrangements are being developed that may involve new types of contracts that involve other parties, including those involving payments to providers, risk sharing of administrative expense with carriers, and so on. Details of these arrangements must also be reviewed carefully.

4.12 In a fully insured, pooled arrangement, specified benefits are covered by the insurance company. The insurance company pools the experience of the plan with that of other similar businesses and assumes the financial risk of adverse experience. In such an arrangement, a plan generally has no obligation for benefits covered by the arrangement other than the payment of premiums due to the insurance company (see paragraph 4.44).

4.13 In a fully insured experience-rated arrangement, specified benefits are paid by the insurance company that assumes all the financial risk. Contract experience is monitored by the insurance company. Contract experience may or may not include the experience of other similar contract holders. To the extent that benefits incurred plus risk charges and administration costs are less than premiums paid, the plan is entitled to an experience-rating refund or dividend (see paragraphs 4.32 and 4.33). If the total of benefits incurred, risk charges, and administrative costs exceeds premiums, the accumulated loss is generally borne by the insurance company but may be carried over to future periods until it has been recovered (see paragraphs 4.45 and 4.46). The plan often has no obligation to continue coverage or to reimburse the carrier for any accumulated loss, although there are certain types of contracts that require additional payments by the plan.

4.14 In a minimum premium plan arrangement, specified benefits are also paid by the insurance company. The insurance contract establishes a dollar limit, or *trigger point*. All claims paid by the insurance company below the trigger point are reimbursed by the plan to the insurance company. The insurance company is not reimbursed for benefits incurred that exceed the trigger point. This type of funding arrangement requires the plan to fund the full claims experience up to the trigger point. Minimum premium plan arrangements may have characteristics of both self-funded and fully insured experience-rated arrangements. Details of each arrangement must be reviewed carefully to determined the specific benefit obligations assumed by the insurance company.

4.15 In a stop-loss insurance arrangement, a plan's obligation for any plan participant's claims may be limited to a fixed dollar amount, or the plan's total obligation may be limited to a maximum percentage (for example, 125 percent) of a preset expected claims level. These arrangements are commonly used with administrative service arrangements. The insurance company assumes the benefit obligation in excess of the limit. Stop-loss insurance arrangements may have characteristics of both self-funded and fully insured arrangements. Stop-loss arrangements of this type may be described by a variety of terms; therefore, details of all insurance or administrative arrangements should be reviewed carefully to determine if stop-loss provisions are included and to determine the specific benefit obligations assumed by the insurance company.

4.16 In an administrative service arrangement, the plan retains the full obligation for plan benefits. The plan may engage an insurance company or other third party to act as the plan administrator. The administrator makes all benefit payments, charges the plan for those payments, and collects a fee for the services provided.

Financial Statements of Defined-Benefit Health and Welfare Plans

4.17 The objective of financial reporting by defined-benefit health and welfare plans is the same as that of defined-benefit pension plans; both types of plans provide a determinable benefit. Accordingly, the primary objective of the financial statements of a defined-benefit health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefit obligations when due. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (*b*) benefit obligations, (*c*) the results of transactions and events that affect the information about those resources and obligations, and (*d*) other factors necessary for users to understand the information provided.[14]

4.18 The financial statements of a defined-benefit health and welfare plan prepared in accordance with GAAP[15] should be prepared on the accrual basis of accounting and include—

- A statement of net assets available for benefits as of the end of the plan year (see paragraphs 4.23 through 4.37).
- A statement of changes in net assets available for benefits for the year then ended (see paragraphs 4.38 and 4.39).
- Information regarding the plan's benefit obligations as of the end of the plan year (see paragraphs 4.40 through 4.53).
- Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the plan's benefit obligations (see paragraphs 4.56 and 4.57).

Information regarding the benefit obligations should be presented on the face of one or more financial statements. The information should be presented in such reasonable detail as is necessary to identify the nature and classification of the obligations.[16]

4.19 FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, provides that employee benefit plans other than pension

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[14] It should be recognized that (*a*) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay its benefit obligations when due and (*b*) financial statements for several plan years may provide more useful information in assessing the plan's future ability to pay benefit obligations than can financial statements for a single year.

[15] Financial statements prepared on a comprehensive basis of accounting other than GAAP should disclose information regarding benefit obligations (see paragraphs 13.20 through 13.23, which discuss auditor's report considerations).

[16] Appendix F provides illustrative financial statements of two health and welfare benefit plans.

plans (such as health and welfare plans, both defined benefit and defined contribution) that provide information similar to that required by FASB Statement No. 35 are not required to provide a statement of cash flows. However, FASB Statement No. 102 encourages that a statement of cash flows be included in the financial statements of an employee benefit plan when such a statement would provide relevant information about the ability of the plan to meet future obligations (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

Financial Statements of Defined-Contribution Health and Welfare Plans

4.20 The objective of financial reporting by a defined-contribution health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefits. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (*b*) the results of transactions and events that affect the information about those resources, and (*c*) other factors necessary for users to understand the information provided.[17]

4.21 The financial statements of a defined-contribution health and welfare plan prepared in accordance with GAAP[18] should be prepared on the accrual basis of accounting and include—

- A statement of net assets available for benefits of the plan as of the end of the plan year (see paragraphs 4.23 through 4.37).
- A statement of changes in net assets available for benefits of the plan for the year then ended (see paragraphs 4.38 and 4.39).

Because a plan's obligation to provide benefits is limited to the amounts accumulated in an individual's account, information regarding benefit obligations is not applicable.

ERISA Reporting Requirements

4.22 ERISA established annual reporting requirements for employee benefit plans, including health and welfare benefit plans.[19] The financial statements required by ERISA are comparative statements of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed-income obligations due that are in default or uncollectible, leases that are in default or uncollectible, and reportable transactions.

Statement of Net Assets Available for Benefits

Investments

4.23 Plan investments, whether they are in the form of equity or debt securities, real estate, or other investments (excluding insurance contracts and

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[17] See footnote 14.

[18] See footnote 15.

[19] ERISA annual reporting requirements, as well as the common exemptions, are described in appendix A.

fully benefit-responsive investment contracts held by defined-contribution health and welfare plans), should be reported at their fair value at the financial statement date.[20] The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for the investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may be used to estimate fair value.[21]

4.24 Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.[22]

4.25 Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values.

4.26 Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

4.27 Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare benefit plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, disclosure of the event or reporting the investment at less than contract value may be appropriate.

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[20] The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is later than the financial statement date and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[21] For an indication of the factors to be considered in determining the discount rate, see paragraph 27 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. The fair value of an investment should be reported net of the brokerage commissions and other costs normally incurred in a sale, if significant (see also paragraphs 2.10 and 2.11).

[22] Footnote deleted.

4.28 *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash provisions*) would not affect a contract's benefit responsiveness.

4.29 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

4.30 Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or have been determined otherwise (paragraph 4.59 specifies additional disclosures related to investments).

Contributions Receivable

4.31 Contributions receivable are the amounts due, as of the date of the financial statements, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants), each of which should be separately identified. They include amounts due pursuant to firm commitments, as well as legal or contractual requirements. With respect to employers' contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution;

(*b*) a consistent pattern of making payments after the end of the plan year, pursuant to an established funding policy that attributes such subsequent payments to the preceding plan year; (*c*) a deduction of a contribution for federal income tax purposes for periods ending on or before the financial statement date; or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[23] Contributions receivable should include an allowance for estimated uncollectible amounts.

Deposits With and Receivables From Insurance Companies and Other Service Providers

4.32 Whether a premium paid to an insurance company represents payment for the transfer of risk or merely represents a deposit will depend on the circumstances of the arrangement. As noted earlier, the nature of payments made to an insurance company should be analyzed to determine the extent to which financial risk has been transferred from the plan to the insurance company. Insurance companies may require that a deposit be maintained that can be applied against possible future losses in excess of current premiums. These deposits should be reported as plan assets until such amounts are used to pay premiums. Similarly, premium stabilization reserves, which exist when premiums paid to an insurance company exceed the total of claims paid and other charges, are held by an insurance company and used to reduce future premium payments. Premium stabilization reserves generally should be reported as assets of the plan until such amounts are used to pay premiums. Disclosure of the nature of this type of deposit or reserve should be made. If such reserves are forfeitable if the insurance contract terminates, this possibility should be considered in recognizing this asset.

4.33 Certain group insurance contracts covering health and welfare benefit plans include a provision for a refund, at the end of the policy year, of the excess of premiums paid over the total of paid claims, required reserves, and the fee charged by the insurance company. Often such experience-rating refunds (or dividends) are not determined by the insurance company for several months after the end of the policy year. In this event, and in cases when the policy year does not coincide with the plan's fiscal year, the refund due as of the financial statement date should be reported as a plan asset if it is probable that a refund is due and the amount can be reasonably estimated. If the amount of the refund cannot be reasonably estimated, that fact should be disclosed.

4.34 Service providers may require that deposits by the plan be applied against claims paid on behalf of plan participants. Such deposits should be reported as plan assets until the deposit is applied against paid claims.

Operating Assets

4.35 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be reported at cost less accumulated depreciation or amortization.

4.36 FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets for assets to be held and used and assets to be

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[23] The existence of an accrued liability in the employer's statement of financial position or a plan's benefit obligations exceeding its net assets available for benefit obligations does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

disposed of. The standard requires that long-lived assets to be held and used by the plan, such as real estate owned by the plan for plan operations, be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement No. 121 also requires long-lived assets the plan expects to dispose of to be reported at the lower of its carrying amount or fair value less cost to sell. Assets to be disposed of should not be depreciated while they are held for disposal. See FASB Statement No. 121 for further accounting and disclosure requirements.

Accrued Liabilities

4.37 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan, or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits.

Statement of Changes in Net Assets Available for Benefits

4.38 The statement of changes in net assets available for benefits should be presented in enough detail to identify the significant changes during the year including, as applicable—

- Contributions from employers, segregated between cash and noncash contributions. A noncash contribution should be reported at fair value at the date of the contribution. The nature of noncash contributions should be described either parenthetically or in a note.
- Contributions from participants, including those collected and remitted by the sponsor.
- Contributions from other identified sources (for example, state subsidies or federal grants).
- The net appreciation or depreciation[24] in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.
- Investment income, excluding the net appreciation or depreciation.
- Income taxes paid or payable, if applicable.
- Payments of claims, excluding payments made by an insurance company pursuant to contracts that are excluded from plan assets.
- Payments of premiums to insurance companies to purchase contracts that are excluded from plan assets.[25]
- Operating and administrative expenses.
- Other changes (such as transfers of assets to or from other plans), if significant.

4.39 The list of minimum disclosures is not intended to define the degree of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful.

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[24] Net appreciation or depreciation includes realized gains and losses on investments that were both purchased and sold during the period. Ordinarily, information regarding the net appreciation or depreciation in the fair value of investments is found in the notes to the financial statements.

[25] Refer to paragraphs 7.28 and 7.29 for further discussion of allocated insurance contracts.

Benefit Obligations

4.40 Benefit obligations[26] for single-employer, multiemployer, and multiple-employer defined-benefit health and welfare benefit plans should include the actuarial present value, as applicable, of the following:

- Claims payable and currently due for active and retired participants
- Premiums due under insurance arrangements
- Claims incurred but not reported to the plan for active participants[27]
- Accumulated eligibility credits for active participants
- Postretirement benefits for—
  - Retired participants, including their beneficiaries and covered dependents
  - Active or terminated participants who are fully eligible to receive benefits
  - Active participants not yet fully eligible to receive benefits

Benefits expected to be earned for future service by active participants (for example, vacation benefits) during the term of their employment should not be included. Benefit obligations should be reported as of the end of the plan year.[28] The effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level should be included in current-period measurements for employees expected to retire after that date.

4.41 As noted previously (see paragraph 4.18), information regarding benefit obligations may be presented either in a separate statement or with other information on another financial statement. However, all the information must be located in one place.

Claims

4.42 In an insured health and welfare benefit plan, claims payable and currently due and claims incurred but not yet reported to the plan will be paid by the insurance company. Consequently, they should be excluded from the benefit obligations of the plan. Benefit obligations of a self-funded plan should present the amount of claims payable and currently due for active and retired participants, dependents, and beneficiaries and IBNR for active participants. IBNR for retired participants is included in the postretirement benefit obligation.[29]

4.43 For a self-funded plan, the cost of IBNR should be measured at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims. Estimated ultimate cost should reflect the plan's obligation

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[26] Administrative expenses expected to be paid by the plan (not those paid by the sponsor) that are associated with providing benefit obligations shall be reflected by appropriately adjusting the assumed rates of return. The adjustment of the assumed rates of return shall be separately disclosed.

[27] IBNR may be computed in the aggregate for active participants and retirees. When the IBNR for retirees is not included in the postretirement benefit obligation, it may be included in claims incurred but not reported.

[28] Postretirement benefit obligations should be determined as of the end of the plan year or, if used consistently from year to year, as of a date not more than three months prior to that date, in accordance with paragraph 72 of FASB Statement No. 106.

[29] See footnote 27.

to pay claims to or for participants, regardless of status of employment, beyond the financial statement date pursuant to the provisions of the plan or regulatory requirements. For example, an individual contracts a terminal disease or has a catastrophic accident in December. The claim is reported to the plan subsequent to year-end. Treatment is ongoing and is expected to continue throughout the next year. The plan does not require any return to work and will fully cover all services. The actuarial present value of the obligation for all future payments to be made as of the plan year end should be included as a benefit obligation in IBNR.

Premiums Due Under Insurance Arrangements

4.44 Benefits to participants may be provided through insurance arrangements that transfer the risks of loss or liability to an insurance company (see paragraphs 4.12 through 4.16). Group insurance contracts for health and welfare plans are usually written for a one-year period, although the contract may provide for annual renewal. The contract generally specifies, among other things, the schedule of benefits, eligibility rules, premium rate per eligible participant, and the date that premiums are due. The benefit obligations should include any obligation for premiums due but not paid.

4.45 If the insurance contract requires payment of additional premiums (for example, retrospective premiums) when the loss ratio exceeds a specified percentage, an obligation for the estimated additional premiums should be included in the benefit obligations.

4.46 Experience ratings determined by the insurance company or by estimates (see paragraph 4.13) may result in a premium deficit. Premium deficits should be included in the benefit obligations if (*a*) it is probable that the deficit will be applied against the amounts of future premiums or future experience-rating refunds[30] and (*b*) the amount can be reasonably estimated. If no obligation is included for a premium deficit because either or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made if it is reasonably possible that a loss or an additional loss has been incurred.

Accumulated Eligibility Credits

4.47 Plans may provide for the payment of insurance premiums or benefits for a period of time for those participants who have accumulated a sufficient number of eligibility credits or hours. Eligible participants are provided with insurance coverage during periods of unemployment, when employer contributions to the plan would not otherwise provide coverage or benefits. At the financial statement date, such accumulated eligibility credits represent an obligation of the plan arising from prior employee service for which employer contributions have been received. This benefit obligation is generally determined by applying current insurance premium rates to accumulated eligibility credits or, for a self-funded plan, by applying the average cost of benefits per eligible participant to accumulated eligibility credits. In either case, the obligation for accumulated eligibility credits should consider assumptions for mortality and expected employee turnover or other appropriate adjustments, to reflect the obligation at the amount expected to be paid.

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[30] This determination should consider (*a*) the extent to which the insurance contract requires payment of such deficits and (*b*) the plan's intention, if any, to transfer coverage to another insurance company.

Postretirement Benefit Obligations

4.48 Health and welfare benefit plans may continue to provide benefits to participants after retirement (postretirement benefits). Those benefits may commence immediately upon termination of service or payment may be deferred until the participant attains a specified age. If a plan provides postretirement benefits to participants, an estimated amount for those benefits, as described below should be included in the benefit obligations.

4.49 The postretirement benefit obligation as of the measurement date is the actuarial present value of all future benefits attributed to plan participants' services rendered to that date, assuming the plan continues in effect and all assumptions about future events are fulfilled. Postretirement benefits comprise benefits expected to be paid to or on behalf of any retired or active participant, terminated participant, beneficiary, or covered dependent who is expected to receive benefits under the health and welfare benefit plan. Postretirement benefits expected to be paid to or for an active participant, beneficiary, or covered dependent who is still earning his or her postretirement benefits (that is, one who is not yet fully eligible) should be measured over the participant's credited period of service up to the date when full eligibility for benefits is attained.[31]

4.50 If a multiemployer health and welfare benefit plan provides postretirement benefits, the benefit obligations must include the postretirement benefit obligation. Consideration should be given to the promises currently made to employees and the history of making such payments to retirees. The fact that benefits may be reduced or even potentially eliminated would not ordinarily affect the promise made as of the end of the plan year unless the change meets the substantive plan criteria of FASB Statement No. 106 (for example, an amendment is in place or has been communicated to employees). The fact that the contributing employers of a multiemployer plan do not record a similar obligation under FASB Statement No. 106 does not affect the accounting for the obligations by the plan.

4.51 The postretirement benefit obligation should be measured using the plan's written provisions to the extent possible, as well as the substantive plan if it differs from the written plan. In many health and welfare benefit plans, postretirement benefits are not defined as a specified amount for each year of service. FASB Statement No. 106, paragraphs 23 through 44, describes the measurement of the postretirement benefit obligation. For multiemployer plans that do not have date-of-hire information as required by paragraph 44 of FASB Statement No. 106, reasonable estimates thereof should be used to measure the obligation. Death or disability benefits provided outside of a pension plan (when the employee is considered to be retired) should also be included in the calculation of the postretirement benefit obligation. Benefits that are provided through an insurance contract should be excluded.[32]

4.52 In measuring the postretirement benefit obligation explicit assumptions must be used, each of which represents the best estimate of a particular

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[31] For example, if a participant has worked eight years and must work another sixteen to be fully eligible for benefits after retirement, one-third of the postretirement benefits have been earned and should be included in the postretirement benefit obligation if it is probable that the employee will work the remaining sixteen years.

[32] Insured plans should be reviewed carefully to determine the extent to which postretirement benefits are insured. Currently, except for single-premium life insurance contracts, few, if any, insurance contracts unconditionally obligate an insurance company to provide most forms of postretirement benefits.

future event. All assumptions should presume that the plan will continue in its present form, unless there is evidence to the contrary. Principal actuarial assumptions used should include—

- Discount rates, used to reflect the time value of money in determining the present value of future cash outflows currently expected to be required to satisfy the liability in the due course of business.
- The timing and amount of future postretirement benefit payments (taking into consideration per capita claims cost by age, health care cost-trend rates, current Medicare reimbursement rates, retirement age, dependency status, and mortality).
- Salary progression (for pay-related plans).
- The probability of payment (considering turnover, retirement age, dependency status, and mortality).
- Participation rates (for contributory plans).

4.53 The postretirement benefit obligation information should include the following classifications:

- Obligations related to retired plan participants, including their beneficiaries and covered dependents
- Obligations related to active or terminated participants who are fully eligible to receive benefits
- Obligations related to other plan participants not yet fully eligible for benefits

Separate disclosure for each classification for each significant benefit (for example, medical and death) may be appropriate.

4.54* Certain retiree health benefits may be funded through a 401(h) account in a defined benefit pension plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Refer to paragraphs 2.37 through 2.43 of this guide for a detailed discussion of 401(h) accounts. The 401(h) account assets and liabilities used to fund retiree health benefits, and the changes in those assets and liabilities, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets used to fund health benefits, and the changes in those assets, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets and liabilities and changes in them can be shown in the health and welfare benefit plan financial statements in one of two ways. An entity can present that information either as a single line item on the face of the statements or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. If the assets and liabilities are shown as a single line item in the statement of net assets, the changes in net assets also should be shown as a single line item in the statement of changes in net assets. If the assets and liabilities are included in individual asset and liability line items in the statement of net assets, the changes in individual 401(h) amounts should be included in the changes in the individual line items in the statement of changes in net assets, with separate disclosure in the footnotes about the 401(h) amounts included in those

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* The guidance contained in paragraphs 4.54 and 4.55 is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged. See paragraph 20 of the SOP [appendix K of this guide] for transition guidance upon adoption.

individual line items. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. The 401(h) obligations are reported in the health and welfare benefit plan's statement of benefit obligations. Likewise, the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account.

4.55* If retiree health benefit obligations are funded partially through a 401(h) account of the defined benefit pension plan, the plan should also disclose the fact that the assets are available only to pay retiree health benefits. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. Additionally, the notes should include a reconciliation of amounts reported in the financial statements to the amounts reported in the Form 5500 (see paragraph 12.27).

Changes in Benefit Obligations

4.56 Information regarding changes in the benefit obligations within a plan period should be presented to identify significant factors affecting year-to-year changes in benefit obligations. Like the benefit obligation information (see paragraph 4.41), the changes should be presented within the body of the financial statements. Providing such information in the following three categories will generally be sufficient: (*a*) claims payable and premiums due to insurance companies, (*b*) IBNR and eligibility credits, and (*c*) postretirement benefit obligations.

4.57 Minimum disclosure regarding changes in benefit obligations should include the significant effects of (*a*) plan amendments, (*b*) changes in the nature of the plan (mergers or spinoffs), and (*c*) changes in actuarial assumptions (health care cost-trend rate or interest rate). Changes in actuarial assumptions are to be considered as changes in accounting estimates and, therefore, previously reported amounts should not be restated. The significant effects of other factors may also be identified. These include, for example, benefits accumulated,[33] the effects of the time value of money (for interest), and benefits paid. If presented, benefits paid should not include benefit payments made by an insurance company pursuant to a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchases of annuities with amounts allocated from existing investments with the insurance company) should be included in benefits paid.[34] If only the minimum disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the initial and ultimate amounts.

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* The guidance contained in paragraphs 4.54 and 4.55 is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged. See paragraph 20 of the SOP [appendix K of this guide] for transition guidance upon adoption.

[33] Actuarial experience gains or losses may be included with the effects of additional benefits accumulated rather than separately disclosed. If the effects of changes in actuarial assumptions cannot be separately determined, those effects should be included in benefits accumulated and described accordingly.

[34] Because of the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumulated plan benefits. If that information is available, it should be presented as an actuarial experience gain or loss.

Additional Financial Statement Disclosures

4.58 Disclosure of a health and welfare benefit plan's accounting policies should include—[35]

- A description of the methods and significant assumptions used to determine the fair value of investments and the reported value of insurance contracts.
- A description of the methods and significant actuarial assumptions used to determine the plan's benefit obligations. Any significant changes in assumptions made between financial statement dates and their effects should be described.

4.59 The plan's financial statements should also disclose other information.[36] Separate disclosures may be made to the extent that the plan provides both health and other welfare benefits. The disclosures should include, when applicable—

- A brief, general description of the plan agreement, including, but not limited to, participants covered, vesting, and benefit provisions. If a plan agreement or a description thereof providing this information is otherwise published or made available, the description in the financial statement disclosures may be omitted, provided that a reference to the other source is made.
- A description of significant plan amendments adopted during the period, as well as significant changes in the nature of the plan (for example, a plan spin-off or merger with another plan) and changes in actuarial assumptions.
- The funding policy and any changes in the policy made during the plan year. If the benefit obligations exceed the net assets of the plan, the method of funding this deficit, as provided for in the plan agreement or collective bargaining agreement, also should be disclosed.[37] For a contributory plan, the disclosure should state the method of determining participants' contributions.
- The federal income tax status of the plan. There is no determination letter program for health and welfare plans; however a 501(c)(9) VEBA trust must obtain a determination letter to be exempt from taxation.
- The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. Consideration should be given to disclosing the type and extent of insurance coverage, as well as the extent to which risk is transferred (for example, coverage period and claims reported or claims incurred).
- Identification of investments that represent 5 percent or more of total plan assets. Consideration should be given to disclosing provisions of insurance contracts included as plan assets that could cause an impairment of the asset value upon liquidation or other occurrence (for example, surrender charges and market value adjustments).
- The amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties.

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[35] See APB Opinion No. 22.

[36] Certain of the disclosures relate to plans with accumulated assets rather than those with trusts that act more as conduits for benefit payments or insurance premiums.

[37] If significant plan administration or related costs are being borne by the employer, that fact should be disclosed.

- Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.
- Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest financial statement date that significantly increases future benefits attributable to an employee's service rendered before that date, a significant change in the market value of a significant portion of the plan's assets, or the emergence of a catastrophic claim should be disclosed. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not reasonably determinable, the reasons why they are not quantifiable should be disclosed.
- Material lease commitments, other commitments, or contingent liabilities.
- The assumed health care cost-trend rate(s) used to measure the expected cost of benefits covered by the plan for the next year, a general description of the direction and pattern of change in the assumed trend rates thereafter, the ultimate trend rate(s), and when that rate is expected to be achieved.
- For health and welfare benefit plans providing postretirement health care benefits, the effect of a one-percentage-point increase in the assumed health care cost-trend rates for each future year on the postretirement benefit obligation.
- Any modification of the existing cost-sharing provisions that are encompassed by the substantive plan(s) and the existence and nature of any commitment to increase monetary benefits provided by the plan and their effect on the plan's financial statements.
- Termination provisions of the plan and priorities for distribution of assets, if applicable.
- Restrictions, if any, on plan assets (for example, legal restrictions on multiple trusts).
- In a defined contribution health and welfare plan—the accounting policy for, and the amount and disposition of, forfeited nonvested accounts. Specifically, identification of whether those amounts will be used to reduce future employer contributions or will be allocated to participants accounts.

SOP 94-4 requires the following disclosures to be made:

- For benefit-responsive investment contracts in the aggregate:
  - The average yield for each period for which a statement of net assets available for benefits is presented
  - The crediting interest rate as of the date of each statement of net assets available for benefits presented
  - The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the credit-worthiness of the contract issuer or third-party guarantor)

  - The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107, as amended

- A general description of the basis and frequency of determining crediting interest-rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).
- For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

This list does not include information that, in accordance with ERISA requirements, must be disclosed in the schedules filed as part of a plan's annual report. It is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information in the footnotes to the financial statements but not in the schedules is not acceptable to the DOL.

4.60 FASB Statement No. 105, as amended by FASB Statement No. 119, requires all entities, including health and welfare benefit plans, to disclose information principally about financial instruments with off-balance-sheet risk. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87; (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statements No. 60, and No. 97; and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47.

4.61 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of FASB Statement No. 105 are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, futures contracts, and interest-rate and foreign-currency swaps.

4.62 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments:

With Off-Balance-Sheet Risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion No. 22

With Off-Balance-Sheet Credit Risk:

- The amount of the accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

4.63 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

4.64 FASB Statement No. 107, as amended by FASB Statements No. 119 and No. 126, requires all entities except for those covered by the exemption in FASB Statement No. 126,* for which the disclosure is optional, to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a health and welfare plan are included in the scope of FASB Statement No. 107, as amended, and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

4.65 FASB Statement No. 107,** as amended, requires entities except for those covered by the exemption in FASB Statement No. 126,* for which the

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* FASB Statement No. 126 amends FASB Statement No. 107 to make the disclosures prescribed in FASB Statement No. 107 optional for plans that meet all of the following criteria:

a. The plan is a nonpublic entity.

b. The plan's total assets are less than $100 million on the date of the financial statements.

c. The plan has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, other than loan commitments, during the reporting period.

Note that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, replaces paragraph 2(c) of FASB Statement No. 126 (item *c.* above) with the following:

> The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

See the Preface of this guide for a discussion of FASB Statement No. 133.

** See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

disclosure is optional, to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading. See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

4.66 FASB Statement No. 119* requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105* and No. 107.

4.67 FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

Risks and Uncertainties

4.68 SOP 94-6 requires plans to include in their financial statements disclosures about (*a*) the nature of their operations, and (*b*) use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires plans to include in their financial statements disclosures about (*a*) certain significant estimates, and (*b*) current vulnerability due to certain concentrations.

4.69 Certain significant estimates should be disclosed when known information available prior to issuance of the financial statements indicates that (*a*) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events, and (*b*) the effect of the change would be material to the financial statements. For example, the present value of accumulated plan benefits of a defined benefit health and welfare benefit plan could be subject to a material change when—

- Employees covered by the plan work in an industry that experienced a significant economic downturn in the previous year and it is reasonably possible that in the subsequent period a significant number of employees will retire early without a monetary incentive to do so in order to avoid being laid-off with nominal benefits. This could significantly increase the present value of accumulated plan benefits and possibly cause the plan to be underfunded.
- Employees covered by the plan are party to a collective bargaining agreement which was up for renegotiation at year-end and it is reasonably

* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

possible that management's offer to significantly increase pension benefits in lieu of granting the union's request for a significant increase in cash compensation will be accepted within the next year. This could significantly increase the present value of accumulated plan benefits.

- Prior to year-end the employer announced a planned downsizing but had not decided on the number of employees to be terminated, and it is reasonably possible that when the decision is made during the next year, it will result in employees receiving pension benefits earlier than expected and in an amount greater than originally projected.
- It is reasonably possible that there will be a significant decline in the fair value of investments (i.e., financial instruments) during the next year which would change the assumed rates of return used to discount the benefit obligation and therefore could significantly affect the present value of accumulated plan benefits.

4.70 Vulnerability from concentrations arises when a plan is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Many plan's participants may be concentrated in a specific industry that carries with it certain risks. Plans may also hold investments and other assets (other than financial instruments for which concentrations are covered by FASB Statement No. 105* rather than SOP 94-6) that are concentrated in a single industry or in a single geographic area. Concentrations should be disclosed if based on known information prior to issuance of the financial statements (*a*) the concentration exits at the date of the financial statements, (*b*) the concentration makes the plan vulnerable to the risk of a near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. For example, if the plan owns several investment properties (i.e., apartment buildings) located in a geographic area that has only one significant employer and that employer announced last year that it is considering leaving the area and it is reasonably possible that it will do so within the next year, this could significantly affect the plan's future cash flows from rents and the value of the investment properties.

4.71 Since the disclosure requirements of SOP 94-6 in many circumstances are similar to or overlap the disclosure requirements in certain FASB pronouncements (for example, FASB Statements No. 5 and No. 105), the disclosures required by SOP 94-6 may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

Terminating Plans

4.72 The auditing interpretation "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU section 9508.33–.38), contains applicable guidance regarding the auditor's reporting responsibilities for terminating plans. For purposes of this discussion, a terminating plan includes all plans about which a termination decision has been made regardless of whether the terminating plan will be replaced.

* See the Preface of this guide for a discussion of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

4.73 When the decision has been made to terminate a plan,[38] or a wasting trust—that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits—exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, as described below. If the decision is made after the year end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, section 560, *Subsequent Events,* paragraph .05.

4.74 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis of accounting. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance and certain investment contracts carried at *contract value*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices.

4.75 Benefit obligations should be determined on a liquidation basis, and their value may differ from the actuarial present value of benefit obligations reported for an ongoing plan. Consideration should be given upon termination to whether any or all benefits become vested.

Voluntary Employee Beneficiary Associations (VEBAs)

4.76 The audit requirement with respect to a health and welfare plan that utilizes a VEBA trust, applies to the plan not the VEBA trust. A trust may be established to hold the assets of an employee welfare benefit plan; it may or may not be tax-exempt. A common form of tax-exempt trust is a IRC Section 501(c)(9) trust, referred to as a voluntary employee beneficiary association or VEBA. VEBA trusts generally have no language covering the plan's operations. The governing instrument is limited to the investment and management of plan assets. Disbursements are made as authorized by the plan administrator. Operational attributes of the related plan must still be audited in accordance with this chapter. However, the tax status is unique to the VEBA and the tax requirements of the IRC must be satisfied for the trust to be tax-exempt.

4.77 Paragraph 4.09 explains that a VEBA is one of several arrangements available to hold plan assets of an employee welfare plan. Key considerations in auditing VEBAs arise from the distinct tax regulations associated with VEBAs and oftentimes assets of several welfare plans are commingled into a single VEBA.

4.78 The audit and reporting issues for a VEBA that holds the assets of a single plan of a single sponsor are discussed fully in this chapter and related paragraphs of this guide. When the VEBA holds the assets of several plans of a single employer additional audit issues are present. If the VEBA qualifies as

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[38] See paragraph 12.18, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent written representation about whether there is a present intention to terminate the plan. Refer also to paragraph 10.38, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

a master trust, the master trust rules discussed in paragraph 4.09 will apply. Where the underlying welfare plans have no assets other than those held by the VEBA, the Form 5500 schedules are attached to the master trust filing and need not be included with the separate filing of each participating plan. (See the Instructions to the Form 5500 for guidance on master trust filings.) If the VEBA does not qualify as a master trust, Form 5500 schedules should be prepared for each plan. (See appendix A for a discussion of the Form 5500 schedules.)

Chapter 5
Planning

Audit Scope

5.01 The nature, timing, and extent of auditing procedures to be performed are based on the scope of services requested by the plan administrator. For each audit engagement, the auditor should establish a clear understanding concerning the scope of audit services to be performed and the auditor's responsibilities regarding any supplemental schedules accompanying the basic financial statements. Statement on Auditing Standards (SAS) No. 83, *Establishing an Understanding With the Client*,* requires the auditor to establish an understanding with the client that includes the objectives of the engagement, management's responsibilities, the auditor's responsibilities (including any supplemental schedules accompanying the basic financial statements), and limitations of the engagement. This understanding should be documented in the workpapers, preferably in a written communication with the client. If the auditor believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement. (See paragraph 5.06 for further guidance on such communications and Exhibit 5-4 for an illustrative engagement letter.)

5.02 The auditor may be engaged to audit the financial statements of an employee benefit plan in accordance with generally accepted auditing standards (*full-scope* audit). Alternatively, ERISA section 103(a)(3)(c) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency who acts as trustee or custodian. The election is available, however, only if the trustee or custodian certifies both the *accuracy and completeness* of the information submitted. Certifications that address only accuracy *or* completeness, but not both, do not comply with the DOL's regulation, and therefore are not adequate to allow plan administrators to limit the scope of the audit. This *limited-scope* audit provision does not apply to information about investments held by a broker/dealer or an investment company. In addition, if a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, separate individual plan certifications from the trustee or the custodian should be obtained for the allocation of the assets and the related income

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* In December 1999 the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which amends SAS No. 83, to include in the understanding with the client, management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

> Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted.

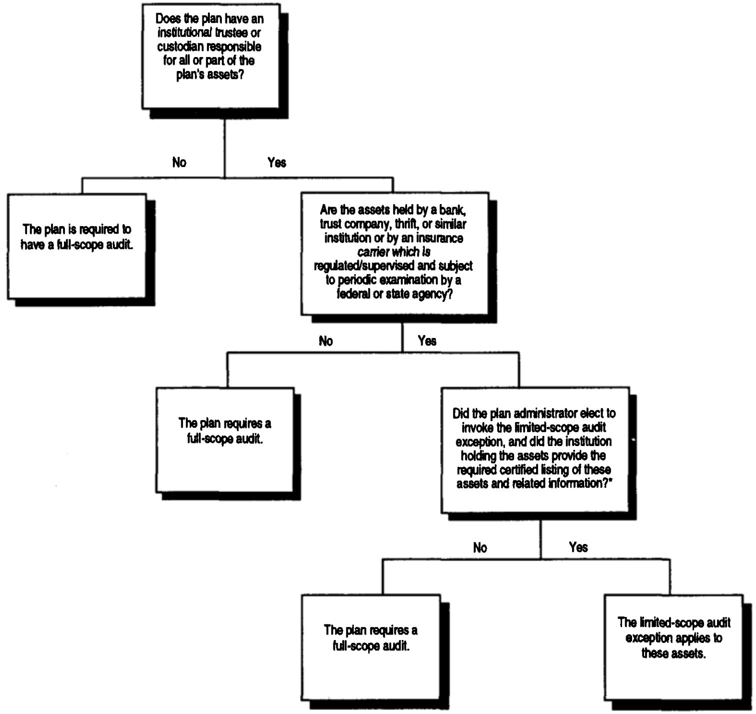
activity to the specific plan. The exemption applies only to *investment* information, and does not extend to benefit payment or other information whether or not it is certified by the trustee or custodian. Thus, except for the investment related activity certified by the trustee/custodian, an auditor conducting a limited-scope audit would need to include in the scope of the audit functions performed by the plan sponsor or other third-party service organizations, such as third-party welfare plan claims administrators or third-party savings plan administrators, if circumstances necessitate. The nature and scope of testing will depend on a variety of factors including the nature of the functions being performed by the third-party service organization, whether a SAS No. 70 report that addresses areas other than investments is available, if deemed necessary, and, if so, the type of report and the related results. (See chapter 6 for a discussion of SAS No. 70.) The limited-scope audit exemption is implemented by 29 CFR 2520.103-8 of the Department of Labor's (DOL) Rules and Regulations for Reporting and Disclosure under ERISA. The limited-scope exemption does not exempt the plan from the requirement to have an audit. Guidance on the auditor's report and responsibilities for this type of limited-scope audit is provided in paragraphs 7.52 and 13.26 through 13.30. Exhibit 5-1 summarizes the conditions that generally allow for limited scope audits in decision tree format.

5.03 Generally, the plan's financial statements accompany the Form 5500 that is filed by the plan administrator. Form 5500 requires footnote disclosure of any differences between the audited financial statements and the statements included as part of the Form 5500. The DOL may reject a filing that does not properly reconcile information contained in the financial statements with information contained in the Form 5500.

Exhibit 5-1

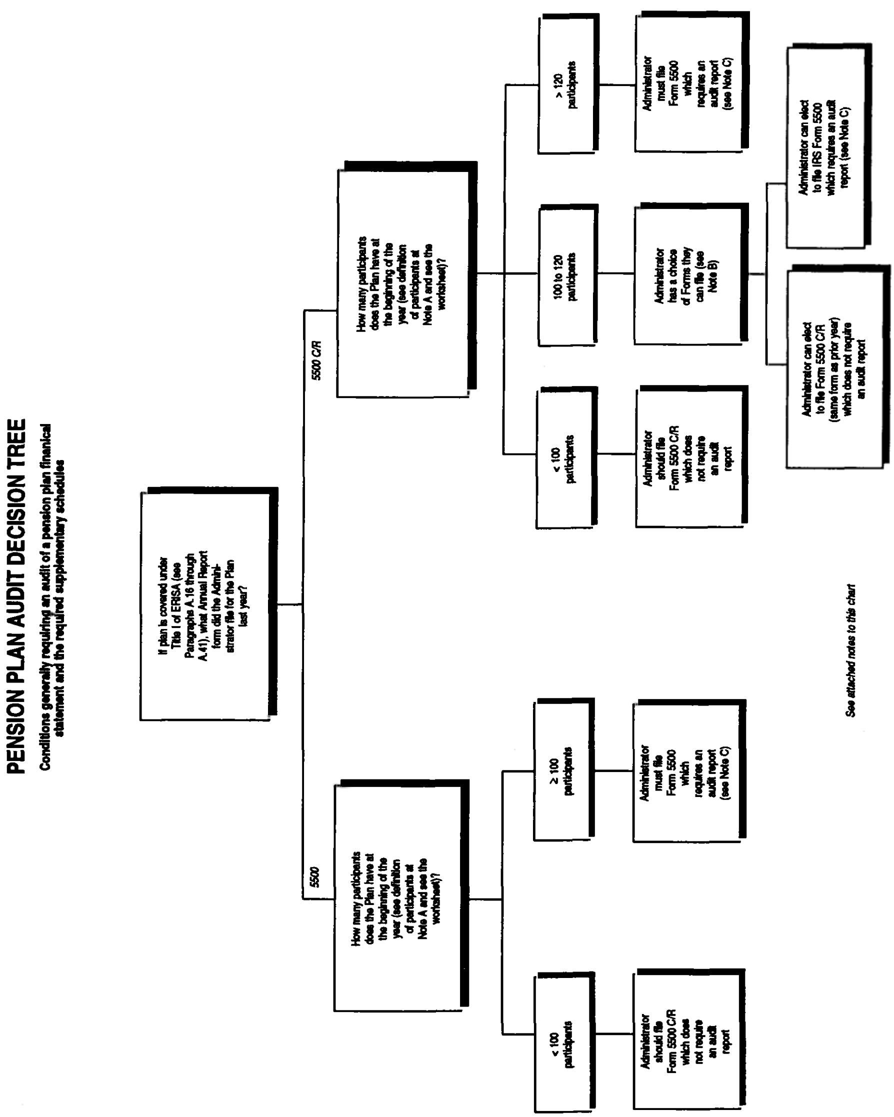
Type of Audit Decision Tree

Conditions Generally Allowing a Limited-Scope Audit Versus a Full-Scope Audit for Employee Benefit Plans Subject to ERISA



* See paragraph 13.26 for guidance on the impact on the independent auditor's report when only a portion of the plan's investments are certified by a qualified custodian or trustee.

Exhibit 5-2


PENSION PLAN AUDIT DECISION TREE
Conditions generally requiring an audit of a pension plan financial statement and the required supplementary schedules
If plan is covered under Title I of ERISA (see Paragraphs A.16 through A.41), what Annual Report form did the Administrator file for the Plan last year?
5500 C/R
5500
How many participants does the Plan have at the beginning of the year (see definition of participants at Note A and see the worksheet)?
< 100 participants
100 to 120 participants
> 120 participants
Administrator should file Form 5500 C/R which does not require an audit report
Administrator has a choice of Forms they can file (see Note B)
Administrator must file Form 5500 which requires an audit report (see Note C)
Administrator can elect to file Form 5500 C/R (same form as prior year) which does not require an audit report
Administrator can elect to file IRS Form 5500 which requires an audit report (see Note C)
How many participants does the Plan have at the beginning of the year (see definition of participants at Note A and see the worksheet)?
≥ 100 participants
< 100 participants
Administrator must file Form 5500 which requires an audit report (see Note C)
Administrator should file Form 5500 C/R which does not require an audit report
See attached notes to this chart

Note A—***Participants*** are defined by the DOL as follows:

Active participants

- Any individuals who are currently in employment covered by a plan and who are earning or retaining credited service under a plan;
- Any individuals who are currently below the integration level in a plan that is integrated with social security, and/or eligible to have the employer make payments to a 401(k) or Section 125 arrangements (participants only have to be eligible for the plan, not necessarily participating in a 401(k) or Section 125 arrangement);
- Any nonvested individuals who are earning or retaining credited service under a plan.

Active participants does not include nonvested former employees who have incurred the break in service period specified in the plan.

Inactive participants

- Any individuals who are retired or separated from employment covered by a plan and who are receiving or entitled to receive benefits.

The term inactive participants does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan.

Deceased participants include:

- Any deceased individuals who have beneficiaries who are receiving or are entitled to receive benefits under the plan.

The term deceased participants does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the beneficiaries of the individual are entitled under the plan.

Note B—***80—120 Rule***

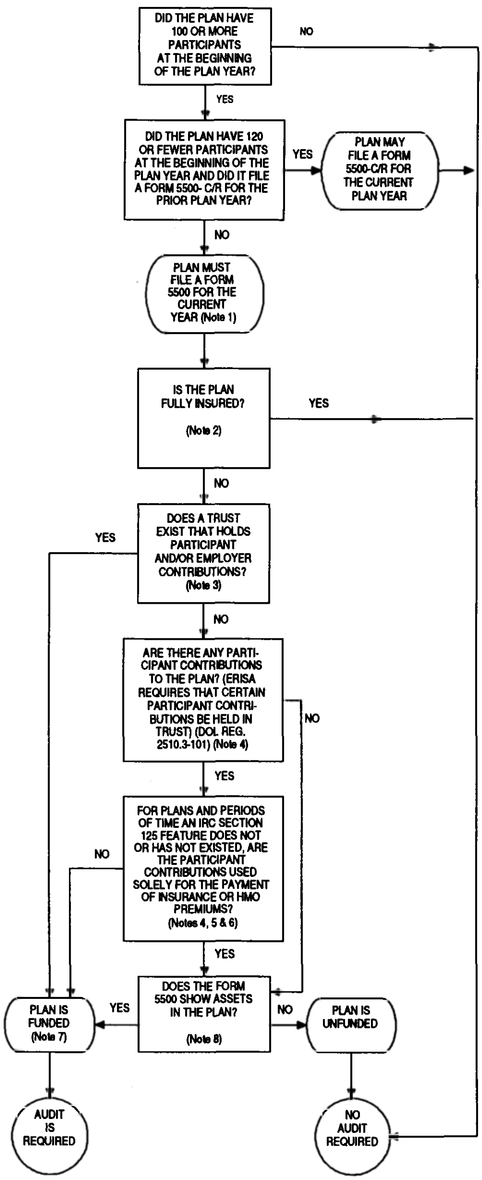
Under DOL reg. 2520.103-1(d), if a plan has between 80 and 120 participants (inclusive) as of the beginning of a plan year, it may elect to file the same category of form it filed the year before and avoid the audit requirement. For 1999, this means that plans with between 80 and 120 participants at the beginning of the plan year that filed a Form 5500-C/R in 1998 may elect to complete the 1999 Form 5500 following the requirements for a "small plan." There is no limit to the number of years this election can be made. DOL officials have indicated that Health and Welfare Plans with 100 or more participants which involve employee contributions generally must have an audit unless employee contributions are used to purchase insurance from a third-party insurer or forwarded to an HMO within prescribed timeframes, even if the sponsor does not maintain a trust and considers the assets to be subject to the rights of general creditors (DOL Reg. 2520.104-44). Careful consideration should be given in these circumstances as to whether an audit is required.

Note C—***Audit Requirement***

If a Form 5500 is filed, an audit of the financial statements generally is required except that (1) pension plans that have a short plan year of seven months or less may elect to defer (but not eliminate) the audit requirement, and (2) pension plans whose sole assets are insurance contracts that fully guarantee benefit payments are not required to be audited (see appendix A).

Exhibit 5-3

WELFARE BENEFIT PLANS AUDIT: DECISION FLOWCHART



Note 1 - Welfare benefit plans filing Form 5500 are generally required to have an audit unless the plan is unfunded, fully insured, or a combination of unfunded and insured. The remainder of the flowchart will assist in the determination of whether this exception applies.

Note 2 - A fully insured welfare benefit plan has its benefits provided **exclusively** through insurance contracts or policies, the premiums of which must be paid **directly** by the employer or employee organization from its general assets or partly from its general assets and partly from contributions by its employees or members (which the employer or organization forwards within three months of receipt). Any such insurance contract must involve the transfer of risk for providing the promised benefits to an insurance company or HMO. Administrative services only (ASO) arrangements with insurance companies with or without stop-loss insurance do not qualify as a fully insured plan.

Note 3 - According to the Department of Labor ("DOL"), under Reg. 2520.104-44, the existence of a separate fund or account for the plan by the employee or a TPA can cause the requirement that funds be paid directly from the general assets of the employer not to be met. For examole, if a separate account is maintained which would be deemed to be a trust under state law, then the related plan would be deemed to be funded under ERISA.

Note 4 - According to DOL technical releases 88-1 and 92-1, participant contributions to a welfare benefit plan which has an IRC Section 125 cafeteria plan feature do not have to be held in trust pending further guidance from the DOL. If a Section 125 arrangement exists, all contributions are deemed to be employer contributions.

Note 5 - According to the DOL, under DOL Reg. 2520.104-44, all participant contributions for plans or periods of time where an IRC Section 125 feature is or was not present must be used solely to pay premiums to an insurer or HMO in order for the financial reporting and audit relief accorded under this regulation to apply. As a result, the insurer or HMO must assume the risk for benefit payments for this relief to apply (e.g., ASO arrangements do not qualify).

Note 6 - Salary reduction amounts (e.g., under Section 125 arrangements) and COBRA premiums are considered participant contributions under ERISA.

Note 7 - If a plan is deemed to be funded for a part of a plan year, then the entire plan year is subject to ERISA's financial reporting and under requirements and all plan-related activity must be reported. If a plan is considered funded the entire plan becomes subject to audit. However, it is not always obvious when a plan is considered funded. The auditor may wish to consult with legal counsel, plan actuaries, and/or the DOL to determine if a plan meets the definition of funded.

Note 8 - DOL will assume the plan is funded if assets are shown on line 31 or line 32 of the 1997 Form 5500. Only plans which are deemed to be funded based on this decision flowchart should show assets on Form 5500.

5.04 ERISA requires that certain supplemental schedules accompany the basic financial statements. Usually the auditor is engaged to report on such supplemental schedules only in relation to the basic financial statements taken as a whole. In such circumstances, the auditor's measure of materiality with regard to the information in the supplemental schedules is the same as that for the financial statements taken as a whole. The auditor's responsibility for reporting on a document that contains information in addition to the client's basic financial statements is described in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and is described in paragraphs 13.15 through 13.17. If the auditor is separately engaged to express an opinion on the supplementary information, as described in SAS No. 62, *Special Reports*, the measurement of materiality must be related to each individual element, account, or item reported on rather than to the aggregate thereof on the basic financial statements taken as a whole.

5.05 In addition, plans with fewer than 100 participants that elect to file the Form 5500 under the 80-120 participant rule, rather than a Form 5500-C/R, are also required to engage an independent auditor. Under this rule, if a plan has between 80 and 120 participants (inclusive) at the beginning of the plan year, the plan may elect to file the same annual return/report form that was filed for the previous year. Exhibit 5-2 summarizes the conditions that generally require audits of pension plan financial statements and schedules under ERISA in decision tree format. Exhibit 5-3 summarizes the conditions that generally require audits of welfare benefit plans under ERISA in decision tree format.

5.06 The understanding with the client concerning the scope of services is frequently documented in a letter, sometimes referred to as an engagement letter or a letter of arrangement. Generally, this understanding would be obtained during the planning phase of an engagement (prior to fieldwork). If this understanding changes during the course of the engagement, the auditor may wish to obtain an updated engagement letter that documents such changes. In addition to the matters listed in SAS No. 83,* the auditor may include the following in an engagement letter for an employee benefit plan audit:

- Whether the engagement represents a full-scope or a limited scope audit (see paragraph 5.02).
- The auditor's responsibility with respect to supplemental schedules accompanying the basic financial statements (see paragraphs 3.28*k* and 5.04).
- The auditor's responsibility with respect to consideration of the plan's qualification for tax-exempt status, with sufficient specificity to make clear that the audit does not contemplate an opinion on plan tax qualification (see paragraphs 12.01 through 12.03).

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* In December 1999 the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which amends SAS No. 83, to include in the understanding with the client, management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

> Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted.

- The auditor's responsibility with respect to information in the Form 5500 (see paragraphs 12.23 through 12.25). The letter might address the fact that, where the auditor's report is to be included in the Form 5500 filing, the Form 5500 should be made available to the auditor before the audit report is issued.
- The auditor's responsibility with respect to reporting matters that come to the auditor's attention regarding lack of compliance with ERISA requirements, making it clear that the audit does not encompass procedures specifically directed at determining such compliance (see paragraph 1.16).
- Whether, due to the complex and/or subjective nature of the subject matter, the audit will require the special skills and knowledge of a specialist. (For example, use of actuaries for defined benefit pension plans and health and welfare plans; or a valuation professional for investments whose valuations are subjective, such as derivative financial instruments, nonpublically held stock and real estate.)
- If applicable, the auditor's responsibilities with respect to electronic filings.

Exhibit 5-4

Following is an illustrative engagement letter (reflecting the requirements of SAS No. 83) for a full-scope employee benefit plan audit engagement. This letter may not contain all matters that pertain to the engagement and therefore should be modified, as appropriate, for the individual circumstances of each engagement. If the engagement is for other than a full scope audit, the letter should be modified accordingly.*

Sample Company Employee Benefit Plan and
Sample Company
[*Address*]

Attention: _____________, Plan Administrator, Sample Company Employee Benefit Plan
_____________, President, Sample Company

Dear _____________ and _____________:

This letter will confirm our understanding of our engagement to audit the financial statements and supplemental schedules of Sample Company Employee Benefit Plan (the Plan) as of December 31, 19X1, and for the year then ended, all of which are to be included in the Plan's Form 5500 filing with the Internal Revenue Service.

We will audit the Plan's financial statements for the year ended December 31, 19X1 for the purpose of expressing an opinion on the fairness with which they present, in all material respects, the financial status of the plan and changes in financial status of the plan** in conformity with generally accepted accounting principles, and whether the supplemental schedules are fairly stated in all material respects in relation to the basic financial statements taken as a whole and in conformity with the Department of Labor's (DOL) Rules and Regulations for Reporting and Disclosure under ERISA.***

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements, therefore, the audit will not necessarily detect misstatements that might exist due to error, fraudulent financial reporting, misappropriation of assets, prohibited transactions

* In December 1999 the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which amends SAS No. 83, to include in the understanding with the client management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

> Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted.

** Financial status is used for defined benefit pension or health and welfare plans. Defined contribution pension or health and welfare plans use net assets available for benefits and changes in net assets available for benefits.

*** If a limited scope audit engagement is to be performed, this paragraph should be deleted.

with parties in interest, or other violations of ERISA rules and regulations. The Plan Administrator is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting such matters. Our report will be addressed to the Plan Administrator and participants.†

We can not provide assurance that an unqualified [limited scope opinion as permitted by Regulation 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA] opinion will be rendered. Circumstances may arise in which it is necessary for us to modify our report or withdraw from the engagement. In such circumstances, our findings or reasons for withdrawal will be communicated to [*the Trustees of the Plan or the members of the Plan Sponsor's Audit Committee*].

The financial statements are the responsibility of the Plan Administrator. Management is also responsible for (1) establishing and maintaining effective internal control over financial reporting, (2) identifying and ensuring that the plan complies with the laws and regulations applicable to its activities, (3) making all financial records and related information available to us, (4) properly recording transactions in the accounting records, (5) making appropriate accounting estimates, (6) safeguarding assets, and (7) providing to us at the conclusion of the engagement a representation letter that, among other things, will confirm management's responsibility for the preparation of the financial statements in conformity with generally accepted accounting principles and the supplemental schedules in conformity with the DOL *Rules and Regulations for Reporting and Disclosure under ERISA*, the availability of financial records and related data, the completeness and availability of all minutes of the Board and committee meetings, and, to the best of their knowledge and belief, the absence of fraud involving management or those employees who have a significant role in the plan's internal control.

The Plan Administrator has responsibility for the financial statements and all representations contained therein. The Plan Administrator also has responsibility for the adoption of sound accounting policies and the implementation of record keeping and internal control to maintain the reliability of the financial statements and to provide reasonable assurance against the possibility of misstatements that are material to the financial statements.

An audit is planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, there is a risk that material errors or fraud (including fraud that may be an illegal act)

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† If a limited scope audit engagement is to be performed, this paragraph and the preceding paragraph should be replaced with the following:

> We will conduct the audit in accordance with generally accepted auditing standards except that, as permitted by Regulation 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA and as instructed by you, we will not perform any auditing procedures with respect to information prepared and certified to by [name of trustee or custodian], the trustee (or custodian), other than comparing that information with the related information included in the financial statements and supplemental schedules. Because of the significance of the information that we will not audit, we will not express an opinion on the financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified to by the trustee (or custodian), will be audited by us in accordance with generally accepted auditing standards, and will be subjected to tests of your accounting records and other procedures as we consider necessary to enable us to express an opinion as to whether they are presented in compliance with the DOL's Rules and Regulations for Reporting and Disclosure under ERISA. Our report will be addressed to the Plan Administrator and participants.

may exist and not be detected by an audit performed in accordance with generally accepted auditing standards.

To the extent that they come to our attention, we will inform management about any material errors, any instances of fraud and, unless clearly inconsequential, any illegal acts. If we become aware of information indicating that an instance of fraud or an illegal act may have occurred which in our judgment would have a material effect on the financial statements of the Plan, we will communicate such information to [the *Trustees of the Plan or the member of the Plan Sponsor's Audit Committee*].

While we are not being engaged to report on the Plan's internal control, we will furnish to you any recommendations about controls that we note during the audit which appear to be of significance under the circumstances. Additionally, if we become aware of any material weaknesses in the Plan's internal control, we will communicate them to you in a separate letter.

The Plan and Sample Company (the Plan Sponsor) agree that all records, documentation, and information we request in connection with our audit will be made available to us, that all material information will be disclosed to us, and that we will have the full cooperation of the Plan's and the Plan Sponsor's personnel.

As a part of our audit, we will perform certain procedures, as required by generally accepted auditing standards, directed at considering the Plan's compliance with applicable Internal Revenue Code requirements for tax exempt status, including inspecting the Plan's latest tax determination letter from the IRS. As we conduct our audit, we will be aware of the possibility that events affecting the Plan's tax status may have occurred. Similarly, we will be aware of the possibility that events affecting the Plan's compliance with the requirements of ERISA may have occurred. We will inform you of any instances of tax or ERISA noncompliance that come to our attention during the course of our audit. You should recognize, however, that our audit is not designed to nor is it intended to determine the Plan's overall compliance with applicable provisions of the Internal Revenue Code or ERISA.

You have not engaged us to prepare or review the Plan's Form 5500 filing with the Internal Revenue Service and Department of Labor. Because the audited financial statements are required to be filed with the Form 5500, professional standards require that we read the Form 5500 prior to its filing. The purpose of this procedure is to consider whether information, or the manner of its presentation in the Form 5500, is materially inconsistent with the information, or the manner of its presentation, appearing in the financial statements. These procedures are not sufficient nor are they intended to ensure that the form is completely and accurately prepared. In the event that our report is issued prior to our having read the Form 5500, you agree not to attach our report to the financial statements included with the Form 5500 filing until we have read the completed Form 5500.[+]

The working papers for this engagement are the property of [*name of CPA firm*] and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you prior to making them available to requesting parties.[++]

[+] This paragraph should be deleted if the auditor has in fact been engaged to prepare or review the plan's 5500 filing.

[++] If you participate in a peer review program you may wish to add the following paragraph:
Our firm, as well as other accounting firms, participate in a peer review program, covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for their review. If it is, they are bound by professional standards to keep all information confidential.

- We may be requested to make certain working papers available to the Department of Labor (DOL) pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of [*name of audit firm*] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to the DOL. We will mark all information as confidential and maintain control over the duplication of all such information. However, the DOL may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies. You will be billed for additional fees as a result of the aforementioned work.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility, plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees of $_____.

We shall be pleased to discuss this letter with you at any time. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you.

If the above terms are acceptable to the Company and the Plan, and the services outlined are in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Very truly yours,

____
[*Partner's Signature*]

____
[*Firm Name*]

Accepted and agreed to: +++

______________________ [*Plan Administrator's Signature*]#	______________________ [*Sample Company—Chief Financial Officer's Signature*]
______________________ [*Title*]	______________________ [*Title*]
______________________ [*Date*]	______________________ [*Date*]

+++ For multi-employer plans, the engagement letter generally is signed by a trustee or the plan administrator (if the plan trustees vote for the plan administrator to do so).

A copy of the signed letter is generally sent to the audit committee, if one exits.

Planning the Audit

5.07 SAS No. 22, *Planning and Supervision*, as amended by SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports, contains guidance on planning an audit in accordance with generally accepted auditing standards. The planning process involves the development of an overall strategy for the expected conduct of the audit. The nature, timing, and extent of planning will vary according to the type of employee benefit plan, size and complexity of the plan's operations, and any restrictions placed on the audit (see paragraph 5.02). SAS No. 22, as amended, requires a written audit program to be prepared for every audit.

5.08 If the auditor of the plan's financial statements is also the auditor of the financial statements of the sponsoring employer, it may be more efficient for the auditor to coordinate the audits, particularly with regard to the testing of payroll and participant data provided to the plan's actuary.

5.09 Also, as required by SAS No. 22, the auditor should possess sufficient knowledge of matters affecting employee benefit plans, including ERISA, applicable sections of the IRC, and related DOL and IRS regulations. For further discussion of applicable laws and regulations, see appendix A.

5.10 The auditor's considerations in forming an opinion on the financial statements of an employee benefit plan consist of obtaining and evaluating evidential matter regarding management's assertions in the financial statements. Assertions are representations by management that are embodied in the financial statements. They can be either explicit or implicit and can be classified according to the following broad categories: existence and occurrence, completeness, rights and obligations, evaluation and allocation, and presentation and disclosure.

5.11 In selecting particular substantive tests to achieve the audit objectives that the auditor has developed, the auditor considers (*a*) the assessment of the level of control risk, (*b*) the relative risk of material misstatements whether caused by error or fraud, and (*c*) the expected effectiveness and efficiency of tests. These considerations include the materiality of the items being tested, the kind and competence of available evidential matter, and the nature of the audit objective to be achieved. The results of the auditor's substantive tests and his or her assessment of the level of inherent risk and control risk should provide a reasonable basis for the auditor's opinion.

Initial Audits of the Plan

5.12 If the plan's financial statements have not been previously audited, the auditor should apply procedures that are practicable and reasonable in the circumstances to obtain reasonable assurance that the accounting principles used by the plan in the current and the preceding year are consistent. If the plan has maintained adequate records, the auditor ordinarily should be able to apply auditing procedures to determine that generally accepted accounting principles have been consistently applied.

5.13 Certain areas require special consideration in an initial audit of a plan's financial statements. The auditor should consider the completeness of participant data and records of the prior year, especially as they relate to participant eligibility, amounts and types of benefits, eligibility for benefits, and account balances. The nature, timing, and extent of auditing procedures applied by the auditor are a matter of judgment and will vary with such factors as the adequacy of past records, the significance of beginning balances, and the complexity of the plan's operations. Since ERISA requires that audited plan financial statements present comparative statements of net assets available for benefits, the current year statements should be audited and the prior year presented for comparative purposes should be either compiled, reviewed, or audited. Appropriate reference in the audit report should be made to describe the level of responsibility assumed (see paragraph 13.41).

Communication and Coordination

5.14 Communication and coordination considerations are a particularly important aspect in performing an audit of a plan because of the many parties who normally maintain accounting records of the plan or are involved in the administration of the plan, such as the plan sponsor, trustees, administrator, investment trustee, insurance company, other independent auditors, actuary, and attorney.

5.15 SAS No. 61, *Communication With Audit Committees*,* establishes a requirement that the auditor determine that certain matters related to the conduct of an audit are communicated to those who have a responsibility for the oversight of the financial reporting process. Communications required by SAS No. 61 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. Communication with the audit committee (or similar entity as discussed previously) by the auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including the following:

- SAS No. 54, *Illegal Acts by Clients*
- SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*
- SAS No. 71, *Interim Financial Information*
- SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*

Information Gathering

5.16 The early stage of planning ordinarily includes obtaining sufficient information to identify the significant aspects of the audit. The auditor should consider applying the following procedures to gather information for planning the audit.

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* In December 1999 AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, and SAS No. 90, *Audit Committee Communications*. SAS No. 89 amends SAS No. 61 to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted. SAS No. 90 revises SAS No. 61, by adding a new paragraph requiring an auditor of SEC clients to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2000 with earlier application permitted.

a. Discuss with trustees, plan administrator, or other appropriate representative of the plan the scope of the audit. Determine whether the scope of the audit will be restricted (limited-scope audit), for example, to exclude financial information certified by a bank or insurance carrier (paragraph 5.02). The types of reports and other services to be rendered should also be discussed, including the supplementary information, if any, required by ERISA and DOL regulations; the auditor should determine what supplementary information will be reported on, as required by ERISA and DOL regulations, and on what information he or she will disclaim an opinion.

b. Make inquiries of plan management whether—

- The plan's financial statements will be prepared in conformity with generally accepted accounting principles or with another basis of accounting permitted by ERISA or DOL regulations (see paragraphs 13.20 through 13.23).
- Investment assets are held by outside custodians. If investment assets are held by outside custodians, the auditor should determine the location of investments and the nature of safekeeping arrangements, including whether the investments are held in the name of the plan.
- The plan's accounting records and participant data are maintained by the plan sponsor, by a bank, by an insurance carrier, or by other outside parties; and how they are maintained.
- A data processing service center is used.
- Periodic financial statements are prepared.
- The plan maintains a list of *parties in interest*, as defined by ERISA section 3(14).
- The plan has procedures for identifying reportable transactions as defined by ERISA and applicable DOL regulations.
- The plan maintains a list of entities whose employees are participants in the plan.
- The plan has either an audit committee or a group equivalent to an audit committee that has been formally designated oversight of the financial reporting process.
- There is a present intention to terminate the plan.
- They have knowledge of fraud that has been perpetrated on or within the entity, and to obtain management's understanding regarding the risk of fraud occurring in the entity.
- The frequency at which transactions are processed and the frequency at which they are valued are the same (for example daily).
- The plan allows participants to initiate transactions by telephone or in an electronic means (such as the Internet or Intranet).

c. Read the plan instrument, including amendments, to determine, among other things, whether the plan is (1) a single employer or multiemployer plan, (2) a contributory or noncontributory plan, and (3) required to be funded or not, and (4) the nature of the benefits promised.

d. Read agreements with trustees, investment advisors, and insurance companies to determine whether the plan is a self-funded, insured, or split-funded plan. If the plan is an insured or split-funded plan, determine the type of insurance contract (for example, deposit administration, immediate participation guarantee, or individual policy).

e. Review the prior-year financial statements and Form 5500, filings with the IRS and DOL and related correspondence, and the status of IRS determination letters and DOL advisory or exemption opinions, if any. Consider the tax-exempt status of the plan, including whether the plan has procedures for assuring compliance with applicable IRC plan qualification requirements.

f. Determine the extent of involvement, if any, of specialists, internal auditors, and other independent auditors.

g. Read reports from the plan's actuary, bank or trustee, insurance company, service auditors, other independent auditors, and internal auditors. After reading these reports, communications may be necessary with the preparers of these reports to determine the extent of audit procedures or the ability to rely on the content of any of these reports.

h. Consider discussing with actuaries their use of participant and other data that is significant to the actuarial computations. Determine the extent of testing of participant data that is necessary by the auditor.

Audit Risk

5.17 In determining the scope of audit procedures to be performed, the auditor should be aware that certain aspects of employee benefit plans are usually subject to a greater level of audit risk. The risk of error is greater for some balances or classes of transactions than others. Also, financial statement assertions derived from accounting estimates pose greater risk than do those derived from relatively routine, factual data.

5.18 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* as amended by SAS No. 82, provides guidance on the auditor's consideration of audit risk and materiality when planning or performing an audit of financial statements in accordance with generally accepted auditing standards. SAS No. 47, as amended, provides that the determination of the scope of the auditing procedures is directly related to the consideration of audit risk and indicates that the risk of material misstatement of the financial statements due to fraud is part of audit risk. A few areas presenting particular audit risk when auditing employee benefit plans are (*a*) the fair market value of investments with no readily ascertainable market, (*b*) new types of investments, (*c*) benefit amounts, and (*d*) transactions initiated by telephone or electronic means (such as the Internet or Intranet).

5.19 The auditor's judgment about the level of risk on the audit may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of the audit, and degree of professional skepticism. For example, if an aspect of the audit is judged to involve high risk, the auditor should consider staffing the engagement with auditors having appropriate relevant experience in auditing the aspect assessed to have high risk, increase the extent of audit work, and use a higher degree of professional skepticism.

5.20 SAS No. 82* describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement, whether caused by error or fraud, and provides guidance on what should be done to meet those responsibilities. Specifically, SAS No. 82 requires the auditor to assess the risk of

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* SAS No. 82 supersedes SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and amends SAS No. 47, and SAS No. 1, sections 110, *Responsibilities and Functions of the Independent Auditor*, and 230, *Due Care in the Performance of Work*.

material misstatement due to fraud and provides categories of fraud risk factors to be considered in the auditor's assessment. It provides guidance on how the auditor responds to the results of the assessment, provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud, describes related documentation requirements, and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

5.21 The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (*a*) misstatements arising from fraudulent financial reporting and (*b*) misstatements arising from misappropriation of assets. While such risk factors do not necessarily indicate the existence of fraud, they often have been observed in circumstances where frauds have occurred. (See appendix J for further guidance on fraud risk factors.)

5.22 The auditor is not required to plan the audit to discover information that is indicative of financial stress of employees or adverse relationships between the entity and its employees. Nevertheless, if the auditor becomes aware of such information during the course of the audit, it should be considered in assessing the risk of material misstatement arising from misappropriation of assets.

5.23 In planning the audit, SAS No. 82 requires the auditor to document in the workpapers the assessment of the risk of material misstatement due to fraud. The documentation should include:

- The risk factors identified as present.
- The response to those risk factors.
- Fraud risk factors or other conditions, if any, identified during the performance of the audit that cause the auditor to believe that an additional response is required (and any such response).

5.24 During the planning and performance of the audit, the auditor may identify some of the fraud risk factors as being present at the client. Of these risk factors present, some will be addressed sufficiently by the planned audit procedures; others may require the auditor to extend the audit procedures. SAS No. 82 requires the auditor to document all risk factors identified as present (and the related response) regardless of whether the presence of those risk factors requires extended audit procedures. If no risk factors are identified as being present, the auditor should document that fact.**

Internal Control

5.25 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, describes the components of internal control and explains how an auditor should consider controls in planning and performing an audit. SAS No. 82 notes that this understanding often will affect the auditor's consideration of the significance of fraud risk factors, and the auditor may wish to assess whether there are specific controls that mitigate the risk or whether specific control deficiencies exacerbate the risk. Internal control of employee benefit plans is discussed in chapter 6.

** This paragraph is based on material from the AICPA publication, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*.

Transactions Processed by Independent Organizations

Transactions Processed by Outside Service Organizations

5.26 Many employers "outsource" certain aspects of the administration of their employee benefit plans. Examples include record-keeping and/or benefit payments processed by outside service organizations such as bank trust departments, data processing service bureaus, insurance companies and benefits administrators. Many plans allow participants to initiate transactions by telephone or electronic means (such as the Internet or Intranet). Often, the plan sponsor does not maintain independent accounting records supporting these transactions. SAS No. 70, *Service Organizations*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 88, *Service Organizations and Reporting on Consistency*, provides guidance on the factors an independent auditor should consider when auditing the financial statements where third-party services are significantly involved in the operation of an employee benefit plan (see chapter 6 for further discussion of SAS No. 70 reports).

Analytical Procedures

5.27 SAS No. 56, *Analytical Procedures*, provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. For planning purposes, these procedures should focus on (*a*) enhancing the auditor's understanding of the plan and the transactions and events that have occurred since the last audit date and (*b*) identifying areas that may represent specific risk relevant to the audit. These procedures can help to identify such things as the existence of unusual transactions and events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

5.28 The following are examples of analytical procedures that the auditor may find useful in planning an audit of an employee benefit plan:

- Comparison of investment balances and rates of return with prior-period amounts
- Analysis of changes in contributions and benefit payments during the current period based on statistical data (for example, number of participants eligible to receive benefits in the current period, number of terminations)

Party in Interest Transactions

5.29 Section 3(14) of ERISA defines a party in interest to include, among others, fiduciaries or employees of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee organization whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee organization, or relatives of such persons just mentioned.

5.30 Certain plan transactions with parties in interest are prohibited under ERISA sections 406 and 407 and are required, without regard to their materiality, to be disclosed in the plan's annual report to the DOL (see paragraph 11.15 for a discussion of the effect of management's failure to properly disclose prohibited party in interest transactions on the auditor's report and appendix A for a discussion of DOL reporting requirements). Prohibited transactions are also of interest from the perspective of the plan's financial statements because they can give rise to significant receivables; a plan fiduciary is liable to make good on losses to the plan resulting from a breach of fiduciary duty and restore to the plan any profits that the fiduciary made through the use of the plan's assets. The potential effects of any contingencies on the plan as a result of engaging in prohibited transactions may need to be disclosed in the plan's financial statements in accordance with the requirements of FASB Statement No. 5.

5.31 Prohibited transactions have an impact on the other party to the transactions as well as on the plan. ERISA provides for the levy of an excise tax on the other party up to the full amount of the prohibited transaction. Also, the fiduciary generally must reverse the transaction, compensate the plan for any losses, and return any profits made using plan assets.

5.32 Transactions between a plan and a party in interest that are generally prohibited under section 406(a) of ERISA include—

- A sale, exchange, or lease of property.
- A loan or other extension of credit.
- The furnishing of goods, services, or facilities.
- A transfer of plan assets to a party in interest for the use or benefit of a party in interest.
- An acquisition of employer securities or real property in violation of the 10 percent limitation.

5.33 There are certain exceptions dealing with party in interest transactions that do not prevent a plan fiduciary from receiving reasonable compensation for services to a plan, or receiving benefits from a plan as a participant or beneficiary, as long as such benefits are in accordance with the terms of a plan as applied to all other participants and beneficiaries. In addition, payments to parties in interest for reasonable compensation for office space and legal, accounting, and other services necessary for the operation of a plan are permitted.

5.34 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all party in interest transactions will be discovered. Nevertheless, during the course of his or her audit, the auditor should be aware of the possible existence of party in interest transactions that are required to be disclosed. Procedures directed toward identifying party in interest transactions that are ordinarily performed during the planning phase of the audit are listed in paragraph 11.05.

5.35 Chapter 11 and appendix A discuss additional procedures and considerations related to party in interest transactions.

5.36 SAS No. 54, *Illegal Acts by Clients*, sets forth the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client. The term *illegal acts*, for purposes of that statement, relates to violations of laws or government regulations. For those illegal acts that are defined in SAS No. 54 as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud (see SAS No. 47, as amended by SAS No. 82).

Accounting Estimates

5.37 In determining the scope of audit procedures to be performed, the auditor should recognize that certain areas of employee benefit plans operations require accounting estimates that may be material in the preparation and presentation of financial statements. SAS No. 57, *Auditing Accounting Estimates*, provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. Although the responsibility for making estimates is that of management, the auditor is responsible for evaluating reasonableness of estimates and should consider appropriate procedures and planning to perform the audit. These should consider both subjective and objective factors.

5.38 Although significant accounting estimates may affect many elements of an employee benefit plan's financial statements, they often affect the asset values for nonreadily marketable investments. In health and welfare plans, estimates may also affect the obligation for incurred but not reported benefit obligations, the obligation for accumulated eligibility credits, and accrued experience-rating adjustments.

Going Concern Considerations

5.39 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended by SAS No. 77, provides guidance to the auditor with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. For financial reporting purposes, continuation of a plan as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the plan's ability to continue to meet its obligations as they become due without an extraordinary contribution by the sponsor or substantial disposition of assets outside the ordinary course of business, externally forced revision of its operations, or similar actions. During the course of the audit, the auditor may become aware of information that raises substantial doubt about the plan sponsor's ability to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminently potential impact on the plan entity and should consider the sponsor's plans for dealing with its conditions.

5.40 SAS No. 59, as amended, states that the auditor has a responsibility to evaluate whether there is substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor considers the results of the procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit to identify conditions and events that, when considered in the aggregate, create substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time. If the auditor determines that substantial doubt about the plan's ability to continue as a going concern does exist, an explanatory paragraph is required regardless of the auditor's assessment of asset recoverability and amount and classification of liabilities. For example, if the sponsoring employer intends to terminate the plan within twelve months of the date of the financial statements, the auditor should include an explanatory paragraph in his or her report that discloses that fact. SAS No. 59 is amended to preclude the use of conditional language in expressing a conclusion concerning the existence of substantial doubt about the plan's ability to continue as a going concern in a going-concern explanatory paragraph.

Chapter 6

Internal Control

6.01 The second standard of fieldwork, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, states that a sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. The following paragraphs summarize the auditor's consideration of internal control under SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended.

> An entity's internal control consists of five interrelated components: the control environment, risk assessment, control activities, information and communication, and monitoring. In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the plan and by the service organization whose services are part of the plan's information system.
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> After obtaining this understanding, the auditor assesses control risk for the assertions (existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure) embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control) because he or she believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a control that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.
>
> After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.
>
> The auditor uses the knowledge provided by the understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

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[1] Internal control also may be referred to as internal control structure.

Considering Internal Control

6.02 In obtaining an understanding of the control environment, the auditor gains knowledge about the overall attitude, awareness, and actions of the plan administrator, board of trustees, and others concerning the importance of control and its emphasis in the entity. In this connection, the auditor considers management's philosophy and operating style, the plan's organizational structure, methods of assigning authority and responsibility, management's integrity and ethical values, management's commitment to competence, and other factors related to the control environment. In gaining an understanding of the control environment, the auditor should normally consider the plan administrator's and others' attitudes, awareness, and actions related to ERISA or other compliance matters (for example, ERISA's prohibited transaction rules) that might affect the plan's financial statements and schedules.

6.03 The auditor's understanding of the accounting system and control activities is ordinarily obtained through discussion with plan personnel and review of documents in the office of the plan administrator (appendix B contains examples of certain controls a plan might establish). The understanding of the accounting system and relevant control activities, along with information about the control environment, is used to assess the risk of a material misstatement in financial statement assertions.

6.04 In some cases, a third-party administrator or service organization, such as a bank trustee, insurance company, or contract administrator (hereafter referred to collectively as service organization), processes certain transactions on behalf of the plan administrator. A service organization's services are part of a plan's information system if they affect any of the following:

- How the plan's transactions are initiated.
- The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the plan's transactions.
- The accounting processing involved from the initiation of the transactions to their inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information.
- The financial reporting process used to prepare the plan's financial statement's including significant accounting estimates and disclosures.

Many plans offer their participants direct access to the service organization by telephone or electronic means (such as the Internet or Intranet). Often, the plan sponsor does not maintain independent accounting records supporting these transactions. The auditor's consideration of components of internal control maintained by the service organization will depend on the nature of the relationship between the plan and service organization.

6.05 If a service organization executes and does the accounting processing of transactions initiated by the plan, there may be a high degree of interaction between the activities at the plan and those at the service organization and, in these circumstances, it may be practicable for the plan to implement effective controls for those transactions. Accordingly, the plan may be able to maintain independent records of transactions authorized to be executed by the service organization. In those circumstances, the auditor may be able to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of tests to be performed without considering those components of internal control maintained by the service organization. An example of such a service organization is a bank trust department that invests and services assets for a plan under a nondiscretionary or directed trust arrangement. However, even in such circumstances, the auditor may still find it more efficient to seek a reduction in the assessed level of control risk for assertions related to transactions executed by the service organization by considering internal control maintained by the service organization.

6.06 If the service organization is authorized by the plan to initiate, execute, and account for the processing of transactions without specific authorization of individual transactions, there is a lower degree of interaction and it may not be practicable for the plan to implement effective controls for those transactions. The plan therefore may not have independent records of the transactions executed by the service organization. In those circumstances, the auditor may not be able to obtain an understanding of the components of internal control, relevant to such transactions, sufficient to plan the audit and to determine the nature, timing, and extent of tests to be performed without considering those components of internal control maintained by the service organization.

6.07 Internal control of a benefit plan consists of the controls at the sponsor as well as the controls at applicable service organizations who perform significant plan functions including but not limited to investment custody, investment management, and payment of benefits. SAS No. 70, *Service Organizations*, as amended by SAS No. 78 and SAS No. 88, *Service Organizations and Reporting on Consistency*, provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity, such as an employee benefit plan, that uses a service organization to process certain transactions that are part of the plan's information system. SAS No. 70, as amended, also provides guidance for independent auditors who issue reports on the processing of transactions by service organizations, such as bank trust departments, third-party administrators, or data processing service organizations, for use by other auditors. A report prepared in accordance with SAS No. 70, as amended, should be designed to provide user auditors with a sufficient understanding of controls at the service organization to plan the audit in accordance with SAS No. 55, as amended. (See Auditing Practice Release *Service Organizations: Applying SAS No. 70*, for additional guidance for user auditors engaged to audit the financial statements of entities that use service organizations and for service auditors engaged to issue reports on the controls of service organizations.)

6.08 Under SAS No. 70, as amended, two types of reports may be issued by a service auditor:

a. A *Report on Controls Placed in Operation* (Type I report) is a report on a service organization's description of its controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements. It addresses whether the description presents fairly, in all material respects, the aspects of the service organization's controls that may be relevant to user organizations; whether such controls were suitably designed to achieve specified control objectives; and whether they had been placed in operation as of a specific date. Such reports may be useful in providing user auditors with an understanding of the service organization's controls sufficient to plan the audit and to design effective tests of controls and substantive tests at the user organization. However, they are not intended to provide user auditors with a basis for reducing their assessment of control risk below the maximum for financial statement assertions affected by the controls.

b. A *Report on Controls Placed in Operation and Tests of Operating Effectiveness* (Type II report) is a report on a service organization's description of its controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements. It addresses whether the description presents fairly, in all material respects, the aspects of the service organization's controls that may be relevant to user organizations; whether such controls were suitably designed to achieve specified control objectives; whether they had been placed in operation as of a specific date; and whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Such reports may be useful in providing user auditors with an understanding of the service organization's controls that is sufficient to plan the audit and may also provide user auditors with a basis for reducing their assessment of control risk below the maximum for financial statement assertions affected by the controls.

6.09 The type of report (Type I or Type II) provided by the service organization may affect the nature, timing, and extent of the audit procedures performed by the auditor of an employee benefit plan. For example, a bank trust department may specify the control objective that security prices are received timely from an authorized source and properly used to price securities. If the bank provides a Type I report, the report should provide the auditor with sufficient information to plan the audit, in other words, to assess whether there are any deficiencies in the design of the controls that could affect financial statement assertions in the user organization's financial statements. However, the auditor would have no basis to conclude that the controls were operating with sufficient effectiveness to achieve the control objective because they have not been tested. Therefore, the auditor may have to expand the testing of prices used at year-end. If, however, the bank issued a Type II report, the auditor could have a basis to rely on the effective operation of controls and therefore reduce the extent of the price testing.

6.10 To the extent that a SAS No. 70 report is available, the engagement team generally should obtain and read the report as the *most efficient* means to obtain an understanding of relevant controls at the service organization. The auditor should read the entire SAS No. 70 document to determine if there are any instances of noncompliance with the service organization's controls identified in either (*a*) the service auditor's report or (*b*) within the body of the document (where the results of testing are described). If the service organization's SAS No. 70 report identifies instances of noncompliance with the service organization's controls, the plan auditor should consider the effect of the findings on the assessed level of control risk for the audit of the plan's financial statements, and as a result the plan auditor may decide to perform additional tests at the service organization or, if possible, perform additional audit procedures at the plan. In certain situations the SAS No. 70 report may identify instances of noncompliance with the service organization's controls but the plan auditor concludes that no additional tests or audit procedures are required because the noncompliance does not affect the assessment of control risk for the plan.

6.11 For a limited-scope audit, the auditor has no responsibility to obtain an understanding of the controls maintained by the certifying institution over assets held and investment transactions executed by the institution. Therefore in a limited-scope engagement, to the extent that the service organization is only providing investment transaction services, no SAS No. 70 report is required.

However, if the provider is also providing services such as benefit payments, a SAS No. 70 report generally should be obtained, if it is available and covers these activities.

6.12 When the administrator elects a full scope audit, even though a limited scope audit could be performed (see paragraphs 5.02 and 13.25 for a discussion of limited scope audits), or where the trustee or custodian does not qualify for the limited scope audit exemption, the auditor may need to obtain an understanding of controls at the trustee or custodian. A similar understanding may be required for information processed by the trustee or custodian related to financial statement components not subject to the limited scope audit exemption, for example, benefit claims or payments. As previously noted, this understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70, as amended, for the service organization. In determining whether a SAS No. 70 report would be useful, the auditor should consider (1) the nature and materiality of the transactions the service organization processes for the user organization, and (2) the degree of interaction between the service organization's activities and those of the user organization. Many SAS No. 70 reports include a list of controls that should be in place at the user organization that may need to be tested by the user auditor. See Exhibit B-2, *Examples of User Controls When a Service Organization is Utilized,* in appendix B of this guide for examples of user controls.

6.13 Service providers are not required to furnish SAS No. 70 reports. If a SAS No. 70 report is not available, information about the nature of the services provided by the service organization that are part of the user organization's information system and the service organization's controls over those services may be available from a wide variety of sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports by internal auditors, or regulatory authorities on the service organization's controls. If the services and the service organization's controls over those services are highly standardized, information obtained through the user auditor's prior experience with the service organization may be helpful in planning the audit. The user auditor may consider utilizing the specific control objectives and selected controls provided in Exhibit B-1 of appendix B of this guide in obtaining this understanding. If the user auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's controls to plan the audit, consideration should be given to contacting the service organization through the user organization, to obtain information or request that a service auditor be engaged to perform procedures at the service organization. If the user auditor is unable to obtain sufficient evidence to achieve the audit objectives, the user auditor should qualify the audit opinion or disclaim an opinion on the financial statements because of a scope limitation. (Historically, the DOL has rejected Form 5500 filings that contain either qualified opinions, adverse opinions or disclaimers of opinion on plan financial statements other than those issued in connection with a limited scope audit pursuant to 29 CFR 2520.103-8 or 12.)

6.14 A report prepared in accordance with SAS No. 70, as amended, for the service organization, for use by auditors of financial statements of employee benefit plans, will typically address in that report the control objectives that are relevant to the specific objectives of employee benefit plans as set forth in Exhibit B-1.

6.15 With the trend toward daily valuation of 401(k) plans, more benefit plans are using service providers to initiate, execute and perform the accounting processing of transactions on behalf of the plan administrator. Oftentimes the plan does not maintain independent accounting records of such transactions. For example, many plan sponsors no longer maintain participant enrollment forms detailing the contribution percentage and the allocation by fund option. In these situations, the auditor may not be able to obtain a sufficient understanding of internal control relevant to such transactions to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those components of internal control maintained by the service organization. This understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70 for the service organization. SAS No. 70 reports generally cover the relevant operations of a service organization; however, certain operations of the service organization may not be addressed in the SAS No. 70 report, and those operations may be significant to the plan audit. In these instances, the engagement team will need to obtain an understanding of the controls in the relevant areas excluded from the scope of the SAS No. 70 report. In some cases, a provider may choose to engage an auditor to prepare a SAS No. 70 report on a rotating basis instead of annually. If this occurs, the engagement team should contact the service organization and discuss with them any system changes, major changes in controls, or mergers/acquisitions that occurred during the year. If these changes have occurred, the engagement team should obtain an understanding of the changes. If the SAS No. 70 report is unavailable, the auditor should consider other appropriate procedures to obtain sufficient evidence to achieve the audit objectives. For example, if participant enrollment forms are unavailable from the plan sponsor, the auditor may wish to confirm the information directly with the participants. Alternatively, the auditor could consider requesting the enrollment forms from the service provider or visiting the service provider to perform the necessary testing. The service provider may be able to provide detailed transaction reports at the plan or participant level, such as telephone or electronic means transaction reports, trade batch reports, distribution summaries, loan ledgers or details of purchases, sales and dividends posted to individual accounts.

6.16 If the independent auditor determines that the service organization had effective controls in place for processing plan transactions during the reporting period, the auditor generally would conclude that it is not necessary to visit or perform additional procedures at the service organization. However, in some situations, the auditor may conclude that additional audit work should be performed at the service organization. Following are some examples of those situations:

- *The service organization issued a SAS No. 70 report describing the controls placed in operation ("Type 1" report) and the auditor wishes to determine whether to reduce the assessed level of control risk at the service organization*—The plan auditor should determine whether it is more efficient to attempt to reduce the assessed level of control risk for the assertions affected by the services performed at the service organization that are part of the plan's information system, or to perform additional audit procedures on the plan's financial statements. If the plan auditor decides it is more efficient to assess the operating effectiveness of the service organization's controls placed in operation, tests of the service organization's controls should be performed, most likely at the service organization.
- *The service organization's SAS No. 70 report covers a different reporting period than the plan's fiscal year*—The plan auditor should make inquiries of the service organization or its auditor to determine whether there were changes in the service organization's controls during

the period not covered by the SAS No. 70 report. If the period not covered is significant, or there have been changes in the controls, the auditor should gain an understanding of the service organization's controls relating to the plan's transactions during the period not covered by the SAS No. 70 report.

- *The service organization's SAS No. 70 report covers only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or the report does not cover activities performed by subservice organizations*—The plan auditor should gain an understanding of the controls related to the services not covered in the SAS No. 70 report as they relate to the plan's transactions processed by the service organization that are part of the plan's information system. If the user auditor does not have sufficient information to assess control risk below the maximum, the plan auditor may decide to perform additional tests of the service organization's controls or perform additional audit procedures on the plan's financial statements. The plan auditor also should obtain a copy of the subservice organization's SAS No. 70 report, if one was issued.

Documentation

6.17 The auditor should document the understanding of the five components of the plan's internal control obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions in which control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions in which the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control, and the nature of the entity's documentation of its internal control.

Reportable Conditions

6.18 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended by SAS No. 78, requires that reportable conditions be communicated to the entity's audit committee or individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one. Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether transactions or adjustments that could be the result of fraud have been detected), he or she should consider whether these risk factors represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee. For a single employer plan that does not have an audit committee, the individual with the level of authority and responsibility equivalent to an audit committee would normally be the named fiduciary, which is often the plan sponsor, an officer thereof, or the sponsor's board of directors. For a multiemployer plan, authority and responsibility equivalent to that of an audit committee would ordinarily rest with the board of trustees.

Chapter 7

Auditing Investments

Background

7.01 The investments of an employee benefit plan often consist of marketable securities, such as common or preferred stocks, bonds, notes, or shares of registered investment companies. Other investments may include real estate, mortgages or other loans, leases, nonreadily marketable securities, or units of participation in common or commingled trust funds maintained by a bank or similar institution. Investments may also be in the form of deposit administration or immediate participation guarantee contracts and individual or pooled separate accounts maintained by an insurance company.

7.02 Within the last decade, many plans have adopted aggressive investment strategies that incorporate a variety of techniques or specialized products to increase investment returns. Use of investment advisors has increased, and their roles are increasingly specialized. It is common for larger plans to use more than one advisor with the intention of increasing diversity in their portfolios through asset allocation. Many of these advisors are specialists selected to invest a portion of the plan's portfolio in a particular product or industry, or to use specialized strategies or techniques.

7.03 During this same period, corporate restructurings have increased the frequency of divestitures and management buyouts. Leveraged buyouts have become a common means of financing these transactions. Corporate financing strategy has given rise to an increase in the use of debt, and a market for high-risk *junk bonds* has been created. More recently, defaults by issuers of junk bonds, as well as the financial difficulties encountered in the savings and loan industry and the need for financial institutions to maintain adequate capital levels, are posing questions of national interest. These and other issues are reflective of the increased inherent risk in many employee benefit plan investment portfolios. This increase is, in part, reflective of the complexity in valuing unique, specialized, or nonreadily marketable securities. It is moreover a reflection of the changing nature of pension and benefit plan portfolios that once were considered to follow conservative investment policies and approaches.

7.04 Advisors also are using existing investments for new or different purposes. Many newer forms of investments, such as repurchase or reverse repurchase agreements, futures and options, and securities lending arrangements, are now available. Collateralized mortgage obligations, real estate mortgage investment conduits (REMICs), and myriad securitized portfolio investments are part of the growing list of specialized real estate related investment securities found in plan portfolios.

7.05 Chapter 5 discusses planning procedures, including those relevant to auditing investments. In planning the audit, the auditor should possess or obtain an understanding of these investments and their audit implications. Similarly, the auditor in planning his or her work should have or obtain an understanding of the role of the investment manager or advisor (for self-directed plans, the participants themselves) and how that role interrelates to the plan, trustee, administrator, or custodian with respect to investment decisions or plan administration.

7.06 Paragraphs 7.07 through 7.25 discuss the auditing objectives and related procedures for auditing trusteed assets, and paragraphs 7.42 through

7.46 discuss the auditing objectives and related procedures for auditing plan assets held with an insurance company. Paragraphs 7.49 and 7.51 discuss the auditing objectives and related procedures for auditing certain other types of plan investments. Paragraph 7.52 discusses the auditing procedures to be performed when the audit is limited with respect to assets held by a bank or similar institution or insurance company.[49] Appendix G provides a summary of objectives, procedures, and other considerations for auditing investments.

Trusteed Assets

7.07 Although investments are an integral part of the assets and operations of an employee benefit plan, the investment activities ordinarily are administratively distinct from other aspects of the plan because the plan administrator or named fiduciary usually engages a trustee or an investment manager, or both.

7.08 In a *directed trust*, including a participant-directed trust, the trustee acts as custodian of a plan's investments and is responsible for collecting investment income and handling trust asset transactions as directed by the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, the participant, or the plan's investment advisor. A *discretionary trust* differs in that the trustee has discretionary authority and control over investments and is authorized by the plan or its investment committee to make investment decisions. A discretionary trust gives the trustee authority to purchase and sell investment assets within the framework of the trust instrument. There are many variations of investment authority that may be given to the trustee, such as a combination of discretionary and directed arrangements within a trust. Furthermore, a plan may have one or more trusts as well as one or more custodial or safekeeping accounts. Many multiemployer plans make use of the services of a third-party administrator (TPA) who contracts to be responsible for plan administration. While TPAs are not normally considered trustees under ERISA, there may be circumstances where they perform investment income collection or other related functions.

7.09 Trustees generally are responsible for the safekeeping of the investments under their control. Sometimes, however, a plan will not appoint a trustee to maintain custody of the plan's investments but, rather, will self-administer the investments and investment transactions and provide for their safekeeping with a custodian.

7.10 The auditor should be aware that the auditing procedures will vary according to the nature of the trustee arrangement (discretionary or directed) and the physical location and control of the plan's records and investments.

Auditing Objectives

7.11 The objectives of auditing procedures applied to investments and related transactions are to provide the auditor with a reasonable basis for concluding—

a. Whether all investments are recorded and exist.

b. Whether investments are owned by the plan and are free of liens, pledges, and other security interests or, if not, whether the security interests are identified.

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[49] See paragraphs 13.26 through 13.30 for a discussion of the scope of the audit when it is limited with respect to assets held by banks, similar institutions, or insurance carriers.

c. Whether investment principal and income transactions are recorded and investments are properly valued in conformity with generally accepted accounting principles.

d. Whether information about investments is properly presented and disclosed.

General Auditing Procedures

7.12 SAS No. 81, *Auditing Investments,** provides guidance on auditing investments in debt and equity securities and investments accounted for under APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* The guidance contained in SAS No. 81 is generally consistent with the guidance contained in this chapter. The auditing procedures to be applied to the investments of a plan ordinarily should include[50]—

a. Obtaining an understanding of the plan's investment strategy and its impact on the plan's investment portfolio. Generally the audit risk associated with valuation of nonreadily marketable, specialized, or unique securities would also be assessed annually as would the determination of whether the inherent risk of investments held by the plan had changed.

b. Obtaining an analysis of changes in investments during the period. The analysis ordinarily will include such information as (1) the name of the issuer, (2) a description of the investment, including the number of shares of stock, par value of bonds, principal amount of mortgages, maturity date, interest rate, and collateral, (3) cost and fair value at the beginning and end of the period and the basis of determining the fair value, and (4) cost of investments acquired and proceeds from investments sold during the period.

c. Obtaining evidence regarding the existence and ownership of investments and information about any liens, pledges, or other security interests, either by direct confirmation from the trustee or custodian or by physical count (in the increasingly less common circumstance in which securities are held in the plan or employer's vault or safe deposit box and registered in the name of the plan or its nominee). With respect to the confirmation procedure, the trustee, such as a bank, is legally responsible for assets held in its trust department. Thus, if a plan's investments are held by a bank's trust department, the auditor ordinarily accepts a confirmation from the bank as evidence of the existence and ownership of the investments. When a confirmation is used, the auditor should obtain information regarding the trustee's responsibility and financial capability. Procedures that the auditor may consider include—

— Reviewing the trust instrument provision to determine the trustee's responsibilities.

— Determining whether the trustee has insurance covering the plan assets under his or her control.

— Reading recent financial statements of the trustee.

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* The AICPA Auditing Standards Board plans to release a new SAS that would supersede SAS No. 81. Readers should be alert for the issuance of this SAS.

[50] When deemed appropriate, these procedures can be used for audits of a directed trust.

The auditing procedures in paragraph 7.15 ordinarily will provide additional evidence regarding the existence and ownership of plan assets.

d. Reviewing minutes, agreements, and confirmations for evidence of liens, pledges, or other security interest in investments.

e. Testing investment transactions by—

— Determining that they were properly authorized.

— Examining brokers' advices, cash records, and other supporting documentation for the historical cost or selling price, quantity, identification, and dates of acquisition and disposal of the investments.[51]

— Comparing prices at which purchases and sales were recorded with published market price ranges on the trade dates.

— Checking the computation of realized and unrealized gains and losses when such items are presented in the statement of changes in net assets or in the notes to the financial statements. (See appendix A for specific DOL rules regarding the computation of realized gains and losses.)

— For daily valued plans, comparing the initiated trade to the detail recordkeeping activity. (When a plan is valued daily a single trade is usually executed at the close of business based upon information provided by the recordkeeper. The trade represents the net of all participant directed activity for that day.

f. Confirming with the plan's custodian or cotrustee broker the status of any securities that are in transit.

g. Determining whether income accruing from investments during the period has been properly recorded. If the investment manager's compensation is material and is based on the plan's investment performance or other similar criteria, a determination should be made that the investment performance criteria affecting such compensation have been adequately tested to serve both purposes. It may be necessary for the plan administrator to engage a specialist as part of this procedure.

h. Testing the fair value of investments by reference to market quotations or other evidence of fair value in accordance with SAS No. 57, *Auditing Accounting Estimates*. If fair value has been determined in good faith by the plan's board of trustees, administrative committee, or other designated party, the plan auditor does not substitute his or her judgment for that of the plan trustees, the plan administrator, or other advisor, because the plan auditor is not an appraiser or investment banker. In establishing the scope of his or her work and when selecting transactions for testing, the auditor should take into consideration the increased complexity inherent in valuing many of the new forms of investments. Procedures that the auditor should consider applying include—

— Reviewing and evaluating the plan's methods and procedures for estimating the fair value of investments.

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[51] The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

- Determining whether the plan's methods and procedures for estimating fair value were followed.
- Testing the underlying documentation supporting the estimates.
- If the investment manager's compensation is material and based on the fair value of plan investments, determining whether the fair value of investments has been adequately tested for this purpose.
- Applying the procedures in SAS No. 73, *Using the Work of a Specialist*. With plans making significantly more investments in nonreadily marketable, specialized, or unique investments, the need to engage a valuation specialist is increasing. The auditor should follow the requirements of SAS No. 73.
- Inquiring if the plan's board of trustees, administrative committee, or other designated party has reviewed and approved estimates of the fair value of plan investments, and reading supporting minutes or other documentation (see paragraph 13.31).

i. Testing the computation of net change in appreciation or depreciation of fair value of investments.

j. Inquiring of the plan administrator or other appropriate parties if they are aware of any situation where the plan's investments or other transactions violate applicable laws or regulations (see chapters 5, 11, and appendix A for a discussion of prohibited party in interest transactions under ERISA).

k. Once the auditor has obtained the requisite investment information from the plan trustee, the auditor should consider obtaining the same type of information from the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor (the directing party) and reviewing and reconciling the directing party's reports (investment position and activity) with those of the trustee.

Discretionary Trusts

7.13 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that in all audits the auditor should obtain an understanding of each of the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit. This understanding is obtained by performing procedures to understand the design of controls relevant to audit planning and whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The knowledge provided by the understanding of internal control and the assessed level of control risk is used in determining the nature, timing, and extent of substantive tests for financial statement assertions. (See chapter 6 for a further discussion of internal control.)

7.14 If investments are maintained in a discretionary trust arrangement (see paragraph 7.08), the plan auditor should apply the auditing procedures discussed in paragraph 7.12 as appropriate to records maintained by the plan. Under a discretionary trust arrangement, the plan will not have an independent record of investment transactions executed by the trust, and thus the plan auditor is unable to examine brokers' advices, cash records, and other supporting documentation to verify investment transactions.

7.15 For the plan auditor to gain sufficient support for transactions executed by the discretionary trust, he or she should do one of the following:

a. If the trustee has engaged an independent auditor to prepare a report on the processing of transactions by a service organization for use by other auditors, the plan auditor should obtain and read a copy of the latest available report and obtain an understanding of each of the five components of the entity's internal control to conduct the plan audit (see SAS No. 70 for service auditors' reports dated after March 31, 1993). Ordinarily it should not be necessary for the plan auditor to review the trust department auditor's single-audit working papers, provided that the plan auditor is satisfied with the professional reputation and independence of the trust department auditor (see SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph 10*a*).

b. If a special-purpose report on the internal control procedures of the trust department cannot be obtained, the plan auditor should apply appropriate procedures at the trust department. In applying those auditing procedures, the plan auditor may consider using the work of the trust department's independent auditor or internal auditor (see SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*).

If the plan auditor is unable to apply the auditing procedures discussed in this paragraph, he or she ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limitation on the scope of the audit (see SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, paragraphs 22 through 26). The significant number of new and different types of investments generally has increased the inherent risk and the audit risk related to plan investments. It is the responsibility of the plan auditor to read the report of the service auditor to determine that the tests performed encompass the types of investments held by the plan. If the report is unclear or it does not address such circumstances, it will be necessary for the auditor, as discussed in SAS No. 70, to supplement his or her understanding of the trust auditor's procedures and conclusions by discussing with the service auditor the scope and results of his or her work.

Investments in Common or Commingled Trust Funds

7.16 A bank common or commingled trust fund may be used to invest some or all of a plan's assets. A plan generally acquires investment units, sometimes referred to as *units of participation*, representing an undivided interest in the underlying assets of the trust. The purchase or redemption price of the units is determined periodically by the trustee, based on the current market values of the underlying assets of the fund. The financial statements of many common and commingled trust funds are examined and reported on by auditors engaged by the bank.

7.17 The objectives of auditing procedures applied to investments in common and commingled trust funds are to provide the auditor with a reasonable basis for concluding—

a. Whether the units of participation held by the plan exist.

b. Whether the units of participation are owned by the plan and are unencumbered.

c. Whether valuation of units of participation at the plan's year-end has been determined in conformity with generally accepted accounting principles.

d. Whether purchase, redemption, and income transactions of the units held by the plan are properly recorded.

7.18 The auditing procedures to be applied to investments in common and commingled trust funds should include—

a. Confirming directly with the trustee the units of participation held by the plan.

b. Examining documents approving and supporting selected investment transactions in units of participation, such as investment committee minutes, trust agreements, or investment guidelines.

c. Obtaining a copy of the current financial statements of the fund and relating the reasonableness of the unit information reported in the fund's financial statements to unit information recorded by the participating plan, including market values, purchase and sales values, and income earned and accrued. In examining documents that provide support for the unit value information, the plan auditor should do the following:

— If the fund's financial statements have been audited by an independent auditor, the plan auditor should obtain and read the fund's financial statements and the auditor's report. The fund's financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor's objectives. The auditor should consider the effect that any reported matters, such as restrictions on redemption or subjectively determined values, may have on the carrying amount of the units of participation held by the plan. If the auditor believes that the carrying amount may be impaired, he or she should consider applying analytical procedures to the interim financial information of the fund from the date of the fund's audited financial statements to determine whether such a loss in value has occurred.

— If the common or commingled trust fund's financial statements are not audited by an independent auditor, the plan auditor should obtain a copy of a service auditor's report relating to the common or commingled trust fund's controls, if such a report is available (see SAS No. 70, *Service Organizations*, as amended). Although a report on controls will not provide the auditor with the same level of assurance as audited financial statements, it will normally provide sufficient evidence as to the effectiveness of the trustee's internal control if the scope of the report includes the appropriate aspects of common and commingled trust funds (for example, determination of unit values and control over share transactions). If the report is not available, appropriate procedures should be performed, including obtaining an understanding of internal control and assessing control risk relating to the common or commingled trust fund. In applying those auditing procedures, the plan auditor may consider using the work of the bank's independent auditor or internal auditor.

If the plan auditor is unable to apply the auditing procedures discussed in this paragraph, ordinarily he or she should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the audit (see SAS No. 58, as amended, paragraphs 22 through 26).

Mutual Funds

7.19 Many employee benefit plans, particularly 401(k) plans and profit sharing plans, hold investments in mutual funds (also known as registered investment companies). Typically, a plan holds units of participation in mutual funds which are valued at quoted market prices (which may fluctuate daily) representing the net asset value of the units held by the plan.

7.20 Many of the audit procedures discussed in paragraph 7.12 are applicable for mutual funds. Such procedures may include the following:

a. Confirming transactions (contributions, transfers and withdrawals) and/or account balances with individual participants.

b. Tracing contributions and withdrawals from the plan recordkeeper's records to the mutual fund's activity statements for the applicable time period.

c. Confirming directly with the mutual fund the number of units of participation held by the plan.

d. Testing the fair value of the investments in mutual funds by comparing per unit values as of year-end to market quotations.

e. Obtaining a copy of the mutual fund's recent financial statements (or alternative source of yield information, such as business journals) and analytically comparing for reasonableness the information in the mutual fund's financial statements to the information recorded by the plan for its units of participation, including market values and the net change in fair value of investments (i.e., realized and unrealized gains and losses) for the period under audit. The mutual fund's financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor's objectives. (The financial statements of mutual funds are typically readily available.)

7.21 Difficulties are often incurred in auditing mutual fund investments with daily valuations, participant-directed automated transactions (e.g., voice-activated telephone systems) and other "paperless transactions." In such circumstances, the plan is often unable to maintain independent records of such transactions necessitating that the auditor obtain an understanding of internal control of the service organization in order to plan the audit in accordance with SAS No. 55, as amended by SAS No. 78. This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70 on the relevant controls of the service organization (typically the recordkeeper, which in certain circumstances may be a service division of the mutual fund organization). (See paragraphs 6.07 through 6.15 for a further discussion of SAS No. 70.) Consideration of the areas and findings addressed in the SAS No. 70 report and whether the SAS No. 70 report is a Type I or Type II report, should be made by the auditor to determine the extent of substantive procedures to perform. For example, if a Type II report is obtained, the auditor may be able to limit tests of certain mutual fund transactions such as those described in 7.20*a* and 7.20*b*.

Master Trusts and Similar Vehicles

7.22 A company that sponsors more than one employee benefit plan or a group of corporations under common control may place assets relating to some or all of the plans into one combined trust account, sometimes referred to as a *master trust*. Each plan has an interest in the assets of the trust, and ownership is represented by a record of proportionate dollar interest or by units of participation. A bank ordinarily serves as the trustee for a master trust, acts as custodian, and may or may not have discretionary control over the assets. If a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, separate individual plan certifications from the trustee or the custodian should be obtained for the allocation of the assets, and the related income activity, to the specific plan.

7.23 Plan administrators normally engage an auditor to report only on the financial statements of individual plans. The auditing objectives and procedures described in paragraphs 7.11 and 7.12 also apply to the activities of a master trust in which a plan participates. When the same auditor examines the master trust and the individual plans that have some or all of their assets in the master trust, it will normally be efficient for the auditor first to apply appropriate procedures to the master trust and then to examine how ownership is attributed to individual plans.

7.24 If the master trust is audited by another independent auditor, the plan auditor should obtain the other auditor's report on the master trust's financial statements. The plan auditor should use this report in a manner that is consistent with his or her use of the report of another auditor on the financial statements of a common or commingled trust fund (see paragraph 7.18*c*). If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement assertions as to plan investments or qualify or disclaim his or her report.

7.25 The plan auditor should review the trust instrument to obtain reasonable assurance that the accounting for the undivided interest is consistent with the instrument. If the instrument does not specify the accounting method, the auditor should be satisfied that all administrators of plans participating in the master trust agree with the method of allocation.

Contracts With Insurance Companies

7.26 A plan may invest assets with an insurance company pursuant to any of a number of different types of contracts. The nature of the contract will determine the related accounting and regulatory reporting requirements.[52]

7.27 The amounts remitted to an insurance company become the assets of the insurance company, for which it, in turn, assumes an obligation to fulfill the contract terms. This differs from a bank trust arrangement in which a bank holds the assets for the plan as a fiduciary and the assets are not included in the bank's financial statements.[53] The extent to which the assets and transactions related to insurance arrangements are recorded in the plan's financial statements, and the extent of auditing procedures to be applied, depend on the terms of the contract with the insurance company.

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[52] As noted in appendix A, plans funded solely with certain types of insurance contracts are not required under ERISA to prepare financial statements or engage an independent auditor.

[53] See paragraphs 7.36 through 7.41 and 7.45 for a discussion of insurance company separate accounts.

7.28 For employee benefit plans, the fundamental basis of distinction in classifying contracts for accounting purposes is (*a*) whether the contributions are currently used to purchase insurance or annuities for the individual participants or (*b*) whether some or all of the contributions are accumulated in an unallocated fund to be used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of service with a vested right.[54] Contractual arrangements under which funds are currently allocated to purchase insurance or annuities for individual participants are referred to as *allocated* funding arrangements, whereas other arrangements are called *unallocated* funding arrangements. Funds in an unallocated contract may be withdrawn or otherwise invested. Some contractual arrangements may involve both allocated and unallocated funding. Essentially, allocated contracts are excluded from, and unallocated contracts are included in, plan assets.[55]

7.29 Allocated funding arrangements include insurance or annuity contracts in which the insurer has a legal obligation to make all benefit payments for which it has received the premiums or requested consideration. Allocated funding instruments can be individual insurance or annuity contracts, group permanent insurance contracts, or conventional deferred group annuity contracts. Some of these contracts may also include unallocated side or auxiliary funds, which ordinarily would be considered plan assets.

7.30 Unallocated funding instruments apply to any arrangement under which employer or employee contributions to an employee benefit plan are held in an undivided fund until they are used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of employment with vested benefits. Unallocated funding ordinarily is associated with a group deposit administration contract (DA) and an immediate participation guarantee contract (IPG).[56] For investment purposes, unallocated funds may be commingled in a general or pooled separate account or held in an individual separate account.

7.31 Determining whether contract assets and related obligations should be reported in the plan's financial statements requires a careful review of the contract. Typical DA and IPG contracts are unallocated funding arrangements, and the value of these contracts generally should be included in a plan's financial statements. Assets held in separate accounts are similarly reflected in the plan's financial statements, because they are unallocated amounts held by the insurance company.

Deposit Administration Contracts

7.32 The term *deposit administration* is applied to a type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Under a DA contract, payments to the insurance company that are intended to provide future benefits to present employees are credited to an account. For investment purposes, the monies in the account are commingled with other assets of the

[54] Although the term "allocated account" is used by insurance companies in connection with defined contribution plans when amounts are recorded in separate participant accounts, the term "allocated," as it is used here, refers to situations in which the obligation to pay defined benefits under the plan is assumed by the insurance company.

[55] See paragraph 2.13 in this guide as well as FASB Statement No. 35, paragraphs 12 and 112 through 126.

[56] The term *group annuity* is frequently applied to a broad category of insurance contracts that provide the vehicle for funding pension benefits. Those include *deferred group annuity* contracts, *deposit administration* contracts, and *immediate participation guarantee* contracts.

insurance company. The account is credited with interest at the rate specified in the contract; it is charged with the purchase price of annuities when participants retire and with any incidental benefits (death, disability, and withdrawal) disbursed directly from the account.

7.33 Although the insurance company will guarantee a minimum stipulated interest rate on funds in the *active life fund* and rates at which annuities may be purchased, it does not guarantee that sufficient funds will be available to meet the cost of annuities to be purchased.

7.34 Experience-rated interest credits on funds in the undivided account are determined by the insurance company, but they are not guaranteed. The calculation of these credits is based on internal records kept by the insurance company for each contract and are determined by the actual investment experience of the insurance company. These interest credits may be paid out, added to the balance of funds in the undivided account, or considered in an overall dividend calculation that also takes into account mortality, other actuarial experience, and reserves required by the insurance company. Under DA contracts, amounts of dividend or rate credits are determined solely at the discretion of the insurance company, which has no contractual obligation to pay a dividend. The contract holder has no contractual right to demand an accounting.

Immediate Participation Guarantee Contracts

7.35 The IPG contract is a variation of the DA contract. In an IPG contract, the account is credited with the contributions received during the contract period plus its share of the insurance company's actual investment income. The IPG contract is written in two forms. Under either form the insurance company is obligated to make lifetime benefit payments to retired employees. One form provides for the actual purchase of annuities as employees retire. There is an annual adjustment to the account to reflect the insurance company's experience under the annuities. In the other form, the IPG contract may accomplish the same objective through a different technique. When an employee retires, pension payments are made directly from the account without the purchase of an annuity. However, the balance of the account must be maintained at the amount required, according to a premium schedule in the contract, to provide for the remaining pension benefits for all current retirees. That portion of the account is referred to as the *retired life fund*. Thus, if necessary, the account could always be used to buy all annuities in force.

Investment Arrangements With Insurance Companies

7.36 A separate account may be used independently of, or as an adjunct to, a DA or IPG contract.

7.37 Separate accounts were developed to allow insured plans to compete with trust funds in making investments and in funding variable annuity plans. The assets of a separate account plan are assets of the insurance company but are not commingled with the insurance company's general assets. The purpose of a separate account is to provide flexibility in the investment of the plan's funds. A separate account may be established solely for one plan or, more commonly, may be pooled with the funds of several plans.

7.38 A separate account in which only one plan participates is generally referred to as an *individual separate account* or as a *separate-separate account*. The investments in the account must be separately identified, and the account is operated similarly to a bank trust fund, although it is included in the insurance company's financial statements.

7.39 A separate account in which several plans participate generally is referred to as a *pooled separate account*. Each plan's share of a pooled separate account is determined on a participation-unit or variable-unit basis.[57] The plan's equity account provides a cumulative record of the number of participation units credited to the account and the number of units allocated or withdrawn from the account. The balance of participation units credited to the account multiplied by the current participation-unit value equals the amount of equity account assets held on behalf of the policyholder at any given time. The participation-unit value is adjusted periodically, usually each business day, to reflect investment results under the separate account.

7.40 Many plans hold guaranteed investment contracts (GICs) in their investment portfolios. Normally issued through the general account, in its simplest form a GIC is a contract between an insurance company and a plan that provides for a guaranteed return on principal invested over a specified time period. Variations include contracts in which the plan is permitted to make deposits or withdrawals during certain windows during the contract life, contracts with multiple maturities (and rates), contracts in which the insurance company guarantees a minimum rate and may credit the contract holder with additional interest, and contracts with floating rates. These contracts are unallocated and are generally to be included as plan assets at their contract value or fair values, as appropriate (see paragraph 3.17).

7.41 For defined contribution plans, another variation of a GIC is commonly referred to as a synthetic GIC. A synthetic GIC is an investment contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the plan owns the assets underlying the synthetic GIC. (With a traditional GIC, the plan owns only the investment contract itself that provides the plan with a call on the contract issuer's assets in the event of default.) Those assets may be held in a trust owned by the plan and typically consist of government securities, private and public mortgage-backed and other asset-backed securities, and investment grade corporate obligations. To enable the plan to realize a specific known value for the assets if it needs to liquidate them to make benefit payments, synthetic GICs utilize a benefit responsive "wrapper" contract issued by a third party that provides market and cash flow risk protection to the plan. (The third-party issuer of the wrapper is an entity other than the plan sponsor, administrator, or trustee and could be the entity that issues the investment contract.) Synthetic GICs are unallocated and are to be included as plan assets at their contract or fair values, as appropriate (see paragraphs 3.17 and 4.13). Because the assets underlying a synthetic GIC are owned by the plan, those assets and the wrapper should be separately valued and disclosed in the Form 5500 *Schedule of Assets Held for Investment Purposes*. The value of the wrapper would be the difference between the fair value of the underlying assets and the contract value attributable by the wrapper to those assets. (See example 5 in the appendix to SOP 94-4, found in appendix H (paragraphs H.12 and H.13) of this guide, for a discussion on synthetic GICs, and paragraph 7.43*d* for suggested audit procedures.)

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[57] In some separate accounts, a plan receives a guaranteed rate of return on funds held in the separate account. A plan's share would be the value of its units determined in accordance with applicable guidance for valuing investment contracts, and the funds held in the separate account should be viewed as an unallocated funding arrangement. Each investment contract in the pooled account should be evaluated individually for benefit responsiveness. However, if the separate account places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive.

Auditing Objectives

7.42 The objectives of auditing procedures applied to plan assets held with an insurance company are to provide the auditor with a reasonable basis for concluding—

a. Whether plan assets, represented by contracts with insurance companies, exist.

b. Whether changes in plan assets during the period are properly recorded and valued in conformity with generally accepted accounting principles.

c. Whether the plan has any intention of seeking to dispose of or terminate the contract.

d. Whether the terms of the contract are being complied with and are appropriately disclosed in the plan's financial statements.

Auditing Procedures

7.43 The auditing procedures to be applied to contracts with insurance companies (to the extent they are applicable to a particular contract) ordinarily should include—

a. Reading the contracts between the contract holder and the insurance company and evaluating whether they are investment or insurance contracts, in accordance with FASB Statement No. 110, if applicable.

b. Confirming the following directly with the insurance company, as applicable:

- Contributions or premium payments made to the fund or account during the year
- Interest, dividends, refunds, credits, and changes in value, and whether such amounts have been charged or credited during the year on an estimated or actual basis
- The value of the funds in the general or separate account at the plan's year-end and the basis for determining such value.
- The amount of insurance company fee and other expenses chargeable during the year
- For insurance contracts with unallocated funds, annuity purchases or benefits paid from unallocated plan assets during the year
- Transfers between various funds and accounts

c. Evaluating whether the characteristics of the contract that restrict the use of assets require disclosure in the financial statements of the plan. For example, if the plan has indicated an intention to dispose of or terminate the contract or the contract contains a termination clause (for example, a market value determination adjustment), the auditor is responsible for performing sufficient procedures either with plan representatives or the insurance company to satisfy the audit objectives identified in the foregoing with respect to proper valuation and appropriate disclosure. Alternatively, if plan management is aware that an event has affected the contract issuer that may require disclosure or, in rare circumstances, may cause plan management to conclude that reporting the investment at a value less than contract value is appropriate, the auditor is responsible for performing sufficient procedures to satisfy the audit objectives identified.

d. For defined contribution plans for which the "wrapper" is benefit responsive, tests of the individual securities or other investments that comprise the assets underlying a synthetic GIC and tests of the related wrapper contract to ascertain the fairness of the values of each to be disclosed by the plan in the Form 5500 *Schedule of Assets Held for Investment Purposes.*

7.44 For contracts in which assets are held in the insurance company's general account (DAs and IPGs), the following additional auditing procedures should be applied:

a. For DA contracts, evaluating the reasonableness of the interest credited to the contracts in relation to any minimum guaranteed interest rate stated in the contract.[58]

b. For IPG contracts, considering the plan administrator's conclusion regarding the basis for recording changes in contract values to recognize investment returns in accordance with the terms of the contract. This conclusion is usually made by referring to investment yield data furnished to the plan by the insurance company. Generally, this evaluation would sufficiently satisfy the auditor regarding the aggregate investment income credited to the contract. If the amount of investment yield credited to the contract, based on current investment returns, does not appear reasonable, the auditor should apply additional procedures, such as making inquiries of the insurance company regarding its compliance with the method required under the terms of the contract for computing investment return. In the event that the plan auditor is unable to obtain assurance as to the reasonableness of the rate of investment return credited, he or she should consider asking the plan administrator to contact the insurance company to arrange for the insurer's independent auditor to perform agreed-upon procedures and issue a report thereon (see SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*). Those procedures would be applied to the insurance company's determination of investment returns in accordance with the contract.

c. Determining that annuity purchases were made on the basis of rates stipulated in the contract. If annuities are not purchased and benefits are paid directly from the fund, benefit payments should be tested in accordance with the auditing procedures discussed in paragraph 9.03.

d. Reading the financial statements and/or obtaining the credit rating of the insurance company.

e. Evaluating whether expenses charged to the contract by the insurance company are in accordance with the insurance contract or are otherwise authorized by the plan.

7.45 For insurance contracts in which investments are made in separate accounts, the auditor should apply the following additional procedures:

a. For investments in which assets are held in individual separate accounts, the plan audit should include the individual investment

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[58] The plan auditor need not apply auditing procedures to the experience fund of a typical DA account or to any similar fund that is used by the insurance company to determine a "discretionary" dividend or rate credit under the contract (see paragraph 7.34).

transactions and documents that provide support for those transactions. The plan auditor should do the following:

- If the separate account's financial statements have been audited by an independent auditor, the plan auditor should obtain and read the separate account's financial statements and the auditor's report. The financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor.
- If the separate account's financial statements have not been audited by an independent auditor, the plan auditor should obtain a copy of a service auditor's report relating to the insurance company's separate account activities, if such a report is available (see SAS No. 70, *Service Organizations*, as amended). Although a report on controls will not provide the auditor with the same level of assurance as audited financial statements, it will normally provide sufficient evidence as to the effectiveness of the insurance company's internal control if the scope of the report includes the appropriate aspects of separate accounts (for example, determination of unit values and control over share transactions). If the report is not available, he or she should apply appropriate procedures at the insurance company, including obtaining an understanding of internal control and assessing control risk relating to the separate account. In applying those auditing procedures, the plan auditor may consider using the work of the insurance company's independent auditor or internal auditor.

b. For investments in pooled separate accounts, the plan audit is concerned with the plan's units of participation in the pooled account, and the plan auditor should examine documents that provide support for those transactions. To perform those procedures, the plan auditor should do the following:

- If the pooled account's financial statements have been audited by an independent auditor, the plan auditor should obtain and read the pooled account's financial statements and the auditor's report. The financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor. The auditor should consider the effect that any reported matters may have on the carrying amounts of the units of participation held by the plan, such as restrictions on redemption or subjectively determined values. If the auditor believes the carrying amount may be impaired, he or she should consider applying analytical procedures to the interim financial information of the pooled account from the date of the account's audited financial statements to determine whether such a loss in value has occurred.
- If the pooled separate account's financial statements have not been audited by an independent auditor, the plan auditor should obtain a copy of a service auditor's report relating to the pooled account's activities, if such a report is available (see SAS No. 70). Although a report on controls will not provide the auditor with the same level of assurance as audited financial statements, it will normally provide sufficient evidence as to the effectiveness of the insurance company's internal control if the scope of the report includes the appropriate aspects of pooled separate accounts

(for example, determination of unit values and control over share transactions). In applying those auditing procedures, the plan auditor may consider using the work of the insurance company's independent auditor or internal auditor.

7.46 If the plan auditor is unable to apply the auditing procedures discussed in paragraphs 7.43 through 7.45, he or she ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the audit (see SAS No. 58, as amended, paragraphs 22 through 26).

Other Investments

7.47 The objectives of auditing procedures applied to participant loans are to provide the auditor with a reasonable basis for concluding—

a. Whether all participant loans exist.

b. Whether the participant loans are recorded and are properly valued in conformity with generally accepted accounting principles.

7.48 The auditing procedures to be applied to participant loans may include—

a. Examining participant loan documentation supporting loans.

b. Confirming loans with participants.

c. Testing that interest is properly recorded.

d. Testing whether the loans were made in conformance with the plan document.

e. Reviewing financial statement classification to ascertain that participant loans are properly reported as plan investments and included in the supplemental schedule of Assets Held for Investment Purposes.

f. Determining whether delinquent loans should be reclassified as distributions. This determination should be made based on the terms of the plan document and related plan policies and procedures. Participant loans in default at year-end should be disclosed on the Form 5500 schedule, *Line 27b—Schedule of Loans or Fixed Income Obligations*. The written terms of the plan, the plan sponsor's written provisions concerning participant loans, and the loan documents determine when a loan is in default.

The fact that the participant pays tax on the amount of the loan does not necessarily mean the loan is considered to be canceled and should be recorded as a distribution in the financial statements. A participant may pay tax on a loan balance because the tax rules have been violated. Depending on the nature of the plan and the plan terms, the loan may remain due and payable, interest may still accrue and the loan may continue to be reported as a plan investment on the financial statements and as an obligation in default on the Form 5500 schedule until it is actually repaid, the default cured in some other manner or the loan is considered to be canceled and therefore is recorded as a distribution.

A plan may call for a previous loan to be considered to be distributed to a participant and considered to be canceled in the event the participant goes into default or otherwise violates the provisions of the documents. In this case, the loan ceases to exist and should be shown as a distribution. The loan is last reported on the Form 5500

Schedule, *Line 27b—Schedule of Loans or Fixed Income Obligations,* if applicable, in the year prior to the year it is canceled and considered to be distributed.

g. Ascertaining that participant loans considered to be delinquent based on the terms of the plan document and related plan policies and procedures are included in the supplemental schedule of Loans in Default or Uncollectible. Delinquent loans are considered to be assets held for investment purposes.

7.49 The objectives of auditing procedures applied to other types of investments and related transactions are to provide the auditor with a reasonable basis for concluding—

a. Whether all investments are recorded and exist.

b. Whether the investments are owned by the plan and are free of liens, pledges, and other security interests, or if not, whether the security interests are identified.

c. Whether investment transactions are recorded and the investments are properly valued in conformity with generally accepted accounting principles.

7.50 The auditing procedures to be applied to other types of investments ordinarily should include—

For real estate

a. Examining closing and other documents supporting the cost of ownership.

b. Examining deeds, title policies, encumbrances, and other evidence related to ownership.

c. Testing the fair value (see paragraph 7.12*h*).

d. Examining current-year tax bills and relating them to property descriptions under (*b*) just listed.

e. Testing investment income from real estate, such as rents, and payments of related expenses, such as taxes and maintenance.

f. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See appendix A for a discussion of *party in interest* and *reportable transactions* under ERISA.)

For loans and mortgages

a. Examining documents, including notes, mortgages, deeds, and insurance policies, supporting selected loans and mortgages.

b. Confirming selected loans and mortgages with borrowers.

c. Testing the fair value, including the extent of collateral, if any (see paragraph 7.12*h*).

d. Testing to see that interest is properly recorded.

e. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See appendix A for a discussion of *party in interest* and *reportable transactions* under ERISA.)

f. Reviewing financial statement classification to ascertain that participant loans are properly reported as plan investments.

Self-Directed Accounts

7.51 Many defined contribution plans with participant directed investment programs also offer a self-directed program to participants. For the purposes of this discussion, a self-directed program is one that allows participants to invest their account balances in any investment desired, within certain specified limitations. Under this type of arrangement, participants can direct investments into the self-directed program in addition to or in lieu of the various formal investment programs offered by the plan. There are also some defined contribution plans that are completely self-directed not offering any formal participant directed investment programs. The self-directed account does not represent a pooled investment vehicle but is an account comprised of individual investments owned by the plan. Often the self-directed accounts contain other investments that are hard-to-value, such as real estate and mortgages. Auditors must obtain an understanding of the individual investments that comprise the account to determine appropriate audit procedures. Paragraphs 7.47 through 7.50 provide audit objectives and procedures relating to other investments. Also, paragraph 3.20 requires plan investments to be detailed in the statement of net assets available for benefits by general type.

Limited-Scope Auditing Procedures

7.52 As discussed in paragraphs 5.02 and 13.26, the audit may be restricted with respect to assets held and transactions executed by certain institutions. In an ERISA limited scope audit, the auditor can limit the scope of testing on any investment information prepared and certified by a qualified trustee or custodian. The auditor has no responsibility to obtain an understanding of internal control maintained by the certifying institution over assets held and transactions executed for the Plan or to assess control risk associated with assets held and transactions executed by the institution. The auditor's responsibilities for any assets covered by the limited-scope exception are (1) to compare the information certified by the plan's trustee or custodian to the financial information contained in the plan's financial statements and (2) to perform the necessary procedures to become satisfied that any received or disbursed amounts (for example, contributions and benefit payments) reported by the trustee or custodian were determined in accordance with the plan provisions.

7.53 Although the auditor is not required to audit certain investment information when the limited scope audit exception is applicable, further investigation and testing are required whenever the auditor becomes aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of preparing financial statements. In addition, if it comes to the auditor's attention that the required supplementary schedules are omitted, do not contain all required information, or contain information that is inaccurate or is inconsistent with the financial statements, the auditor should consider modifying his or her report on the supplementary schedules (see paragraph 13.16). Furthermore, the scope limitation and the corresponding limitation of the auditor's work extends only to investments and related investment activity certified by the qualified trustee/custodian. Plan investments not held by a qualified trustee/custodian, such as real estate, leases, mortgages, and participant loans, and any other investments or assets not covered by such an entity's certification should be subjected to appropriate audit procedures. Moreover, the appropriate audit procedures for all noninvestment related information (for example, benefit payments, employer/employee contributions, and receivables) are the same for a limited scope audit as for a full scope audit.

Chapter 8

Auditing Contributions Received and Related Receivables

8.01 For all types of employee benefit plans, the basis for determining employer and, if applicable, employee contributions is specified in the plan instrument or related documents. For defined benefit plans covered by ERISA, employer annual contributions must also satisfy the minimum funding standards of ERISA. (See paragraphs A.10 through A.13 for a discussion of the funding standard account and minimum funding standards of ERISA.) The existence of an accrued liability in the employer's statement of financial position or of a plan's accumulated benefit obligations in excess of its net assets available for benefits do not, by themselves, provide sufficient support for recognition of a contribution receivable by the plan.

Auditing Objectives

8.02 The objectives of auditing procedures applied to contributions received and related receivables of employee benefit plans are to provide the auditor with a reasonable basis for concluding—

a. Whether the amounts received or due the plan have been determined and recorded and disclosed in the financial statements in conformity with plan documents and generally accepted accounting principles.

b. Whether an appropriate allowance has been made for uncollectible plan contributions receivable in conformity with generally accepted accounting principles.

Auditing Procedures

8.03 The auditing procedures to be applied to employer and employee contributions ordinarily should include—

a. Obtaining a list of participating employers (in a multiemployer plan) and testing its completeness by examining appropriate plan documents (for example, a collective bargaining agreement).

b. Obtaining a schedule of contributions received or receivable and relating the contributions to the listing of participating employers obtained in procedure (*a*) of this list and of other plans under reciprocal arrangements.

c. Testing contribution reports to see that the reports are arithmetically correct and that the contribution rate specified in the plan instrument, including collective bargaining agreements, if applicable, was used.

d. Reconciling contributions received from the schedule obtained in procedure (*b*) to the plan's cash receipts records and bank statements or trustee reports. Sometimes a central bank account is used for the deposit of employer contributions to several related employee benefit plans. In those circumstances it may be necessary to test the amounts transferred to the bank account of the individual employee benefit plan.

e. Testing postings from the employer contribution reports to the participant employee or employer records and from participant records to contribution reports.

f. Confirming directly with contributors amounts received and receivable.

g. Reviewing criteria used by the plan in accruing employer and employee contributions receivable and determining that the accruals have been recorded in accordance with generally accepted accounting principles.

h. Evaluating the reasonableness of the plan's allowance for estimated uncollectible amounts based on testing of collections subsequent to the date of the financial statements and reviewing the status of unpaid amounts.

8.04 The auditor may accomplish the foregoing procedures more efficiently by coordinating the auditing procedures for plan contributions with those for participants' data (see chapter 10). In auditing the financial statements of a multiemployer plan, the auditor may need to make special arrangements to examine employer records. The auditing procedures and related guidance described in paragraph 10.06 may be applicable to those circumstances (see also paragraph 13.28).

Defined Benefit Plans

8.05 In addition to the auditing procedures discussed in paragraph 8.03, procedures that the auditor should consider applying in auditing the financial statements of a defined benefit pension plan or a defined benefit health and welfare plan include—

a. Determining that employer contributions are consistent with the report of the plan's actuary, if applicable.

b. Reviewing the amount contributed and, if applicable, determining that it meets the requirements of the funding standard account (see appendix A for a discussion of the funding standard account).

c. Considering the results of the auditing procedures described in chapter 10 for participants' data and using the work of an actuary when examining the amount recorded as contributions in the plan's financial statements. For example, significant errors in participants' data provided to the actuary may have a material effect on the actuarially determined amount of contributions.

Defined Contribution Plans

8.06 Besides the auditing procedures discussed in paragraph 8.03, additional procedures that the auditor should consider applying in auditing contributions to defined contribution plans include—

a. Reviewing the contribution provisions of the plan instrument and testing compliance with the plan instrument. (The plan instrument of a defined contribution plan often specifies the criteria that must be met for the employer and employee to make a contribution, the formula to determine upper and lower contribution limits, or the rates for determining the contribution.)

b. Comparing the amount of employer contributions recorded in the plan's records to the amount approved by the board of directors of the plan sponsor, if the plan instrument requires that the board of directors determine or approve the employer contribution.

c. Considering, whether forfeited non-vested participant accounts, if any, have been properly applied to reduce contributions if appropriate under provisions of the plan.

d. Considering, if applicable, the results of the auditing procedures described in chapter 10 for participants' data (including any contributions for salary reduction plans).

e. Inquire as to the timing of employee contribution remittances to the plan. Failure of the plan sponsor to remit employee contributions to the plan in accordance with Department of Labor regulations may constitute a prohibited transaction. Additional information on remittance rules can be found in paragraph A.14.

Rollover Contributions

8.07 Many plans allow participants to transfer contributions into the plan from another qualified plan or from an individual retirement account.* Such transfers are known as rollover contributions. The auditing procedures applied to rollover contributions may include—

a. Review plan document to determine that the rollover was made in accordance with plan provisions.

b. Test asset transfer from the former trustee (custodian) to the current trustee (custodian), including verification of the participant-directed investments, if applicable.

c. Review participant recordkeeping account to determine that the rollover amount is properly reflected.

* The contributions should originate from a qualified plan before being transferred to the individual retirement account.

Chapter 9

Auditing Benefit Payments

9.01 The amount, timing, and form of benefits paid or payable to participants and beneficiaries are determined in accordance with the plan instrument or related documents. The plan administrator or his or her agent is responsible for assuring that any disbursements of plan assets satisfy the requirements set forth in the plan instrument and related documents and are otherwise consistent with ERISA.

Auditing Objectives

9.02 The objectives of auditing procedures applied to benefit payments for employee benefit plans are to provide the auditor with a reasonable basis for concluding—

a. Whether the payments are in accordance with plan provisions and related documents.

b. Whether the payments are made to or on behalf of persons entitled to them and only to such persons (that is, that benefit payments are not being made to deceased beneficiaries or to persons other than eligible participants and beneficiaries).

c. Whether transactions are recorded in the proper account, amount, and period.

Auditing Procedures

9.03 The auditing procedures to be applied to benefit payments ordinarily should include—

a. For selected participants receiving benefit payments—
   - Examining the participant's file for type and amount of claim and propriety of required approvals including tracing approval of benefit payments to board of trustees or administrative committee minutes, if applicable. Where disbursements are initiated by telephone, or electronic means (such as the Internet or Intranet) consider confirming disbursements directly with participants, and/or comparing disbursements to a transaction report, if one is maintained. For health and welfare benefit plans, examining service provider statements or other evidence of service rendered.
   - Evaluating the participant's or beneficiary's eligibility (that is, whether the payee meets the plan's eligibility requirements) by: examining evidence of age and employment history data; comparing employment dates, credited service, earnings, and any employee contributions to payroll or other appropriate records; and examining the benefit election form and dependent designation to determine appropriateness of payment, including the form of distribution (for example, lump sum, installments, or annuity contract).

- For plan benefits, such as death and disability benefits, examining a copy of the death certificate and beneficiary form, physician's statement, and other appropriate documents.
- Recomputing benefits based on the plan instrument and related documents, option elected, and pertinent service or salary history. Verifying that all contributions, income and expenses have been properly posted to participant's account prior to making the distribution.
- Recomputing forfeited participant balances based on the vesting provisions of the plan and pertinent service history.
- Comparing the benefit payment amount to cash disbursement records or trustee reports. Reviewing trade reports to determine that correct investments were liquidated at distribution.
- For health and welfare plans, comparing the payment of premiums to an insurance company, prepaid health plan or similar organization on behalf of a participant to the participant's eligibility records.

b. Evaluating whether procedures exist for determining the continued eligibility of participants or beneficiaries to receive benefits to assure that individuals are removed from the benefit rolls upon death and that payments made to individuals over an unusually long number of years are still appropriate.

c. Evaluating whether procedures exist for investigating long-outstanding benefit checks.

d. For defined contribution plans, comparing disbursements to participants with individual participant's account records that have been examined in accordance with the auditing procedures in paragraphs 10.12 through 10.14.

e. For defined contribution pension plans, review the criteria used by the plan to record benefit payments and determine that the benefit payments have been recorded in accordance with generally accepted accounting principles. The auditor should refer to paragraph 3.28*m* for guidance in reporting benefit payments on the statement of net assets available for benefits.

f. For health and welfare plans, review the criteria used by the plan to record benefit payments, and determine that the benefit payments have been recorded in accordance with generally accepted accounting principles. The auditor should refer to paragraphs 4.40 through 4.53 for more complete guidance.

Depending on the results of the procedures described in (*b*) and (*c*) in the preceding list, the auditor may also wish to compare canceled checks with the plan's cash disbursement records or to confirm payment of benefits by corresponding directly with selected participants, service providers, and beneficiaries and comparing signatures with the application for plan benefits, service provider statements, or other appropriate documents.

9.04 In some circumstances, benefit disbursements are determined or made by a third party such as a bank, an insurance company, or other service provider (that is, third-party administrator). In these circumstances, the auditor may need to obtain an understanding of the internal control procedures of the third party. This can be satisfied either through obtaining a service auditor's report in accordance with SAS No. 70, *Service Organizations*, as amended, or through applying appropriate auditing procedures to the third-party administrator.* These procedures are performed irrespective of whether the plan avails itself of the limited-scope audit exemption relating to certain assets held by a bank or similar institution or insurance carrier regulated and supervised and subject to periodic examination by a state or federal agency. The use of such a third party's independent auditor or internal auditors to perform certain of the foregoing procedures may be appropriate in those circumstances.

9.05 For plan's that allow transfers to another qualified plan or to an individual retirement account, otherwise known as rollover distributions, review the plan document to determine that the rollover was made in accordance with plan provisions.

* If a Type II SAS No. 70 report is obtained, that specifically covers the testing of benefit payments, the auditor may be able to limit tests of the benefit payments.

Chapter 10

Auditing Participant Data and Plan Obligations

Participant Data

10.01 The nature of plan benefit obligations and the accounting methods and auditing procedures for them differ with the various types of plans; however, each type requires the testing of certain participant data. The type of participant data to be tested differs according to the type of plan, and from plan to plan within each type. The data used to determine accumulated plan benefits will be identified in the plan instrument or collective bargaining agreement, if applicable. If the plan requires the services of an actuary, an actuarial report may describe or summarize the participant data used by the actuary. The data should be tested by the auditor in accordance with SAS No. 73, *Using the Work of a Specialist* (see paragraphs 10.21 through 10.26 and 10.37 and 10.38 of this guide).

10.02 The objectives of auditing procedures applied to participant data are to provide the auditor with a reasonable basis for concluding (*a*) whether all covered employees have been properly included in employee eligibility records and, if applicable, in contribution reports and (*b*) whether accurate participant data for eligible employees were supplied to the plan administrator and, if appropriate, to the plan actuary.

10.03 The period for which the data are tested will depend on the date as of which the related financial information is presented in the financial statements. For example, if the accumulated plan benefits are actuarially valued as of the beginning of the plan year, the data to be tested will be as of or for the period ending as of that date. Similarly, if contributions are determined on the basis of an actuarial valuation as of the beginning of the plan year, data submitted to the actuary and to be tested by the auditor would be as of that date. If the auditor also audits the employer's financial statements, the auditing procedures applied in the prior year's audit of the employer's financial statements generally need not be duplicated in the audit of the plan's financial statements. The auditor may find that he or she can accomplish the work more efficiently by coordinating the auditing procedures for participant data with procedures for plan contributions and plan benefits described in chapters 8 and 9. The auditor also may be able to reduce the extent of tests of participant data by relying on a SAS No. 70 Type II report (see paragraph 6.08*b*) because entities issuing such reports for recordkeepers often test certain participant data, such as contribution, income, and forfeiture allocations for participant directed investment fund options.

10.04 The types of participant data that ordinarily should be tested in an audit of a plan's financial statements will vary from plan to plan, depending on the factors on which contributions and benefits are determined. In general, the data tested may include—

a. Demographic data, such as sex, marital status, birth date, period of service with the employer, and other service history.

b. Payroll data, such as wage rate, hours worked, earnings, and contributions to the plan, if any.

c. Benefit data for participants receiving benefits, such as benefit levels and benefit options selected.

10.05 In testing the employer's participant records, procedures that should be considered include—

a. Reviewing pertinent sections of the plan instrument and collective bargaining agreement, if applicable, as a basis for considering what participant data should be tested in the audit of the plan's financial statements.

b. Testing the summarization of the payroll journal and schedules of participant data, if applicable, and tracing postings of gross pay to general or subsidiary ledger accounts.

c. Testing payroll data for one or more pay periods and for a number of participants by—
- — Tracing the individual payrolls from the payroll journal to the participants' earnings records.
- — For participants paid on an hourly or piecework basis, testing payroll hours, production tickets, or other supporting evidence and testing the computation of hours.
- — Testing rates of pay to authorizations or union contracts.
- — Testing calculations of earnings.
- — Reviewing personnel files for hiring notice and employment data, pay rates and rate changes, termination notice, sex, birth date, and so forth.

d. If participant files are maintained in the custody of the plan administrator, testing whether the data maintained in those files correspond to the data maintained in employer payroll and personnel files.

10.06 If the auditor is unable to examine the participant records maintained by the employer, which may occur in a multiemployer plan, there may be circumstances, depending on the existing internal control, in which the auditor can obtain the necessary assurance by applying one or more procedures, such as—

a. If the plan administrator maintains records of participant data and maintains internal control to help ensure that data on all participants are included in the records, testing the data on which contributions and actuarially determined amounts are based by direct communication with participants and by comparison with union or other records, if applicable. The auditor may also confirm hours, pay rates, and other appropriate information.

b. If the plan administrator's normal procedures include periodic visits to employers to test data submitted to him or her, reviewing and testing the plan administrator's procedures.

c. Obtaining a report from the auditor of the employer company stating that agreed-upon procedures (as described in paragraph 10.05) have been performed, and obtaining the auditor's findings regarding the procedures applied. In addition, the plan auditor should apply such other auditing procedures as he or she considers necessary in the circumstances. In this regard, it may be necessary for the plan auditor to request the other auditor to apply additional tests (see SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*).

If the auditor is unable to obtain the necessary assurance regarding participant data, he or she ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limitation on the scope of the audit (see SAS No. 58, as amended by SAS No. 79, paragraphs 22 through 26 and paragraphs 13.26 through 13.30 of this guide).

Multiemployer Plans

10.07 In addition to the auditing procedures described in paragraphs 10.05 and 10.06 of this chapter, when auditing the financial statements of multiemployer plans the auditor should consider—

a. Comparing the employers' contribution reports with the information shown in participants' earnings records and comparing hours worked and earnings records with the employer's contribution reports to evaluate whether the participants have been properly included in or excluded from the reports.

b. If significant participant data is not available, the auditor should satisfy himself or herself as to the adequacy of the methods used by the plan administrator or plan actuary to give effect to such missing data.

10.08 When auditing participant data in a multiemployer benefit plan, the auditor is often unable to directly test payroll records. Plan sponsors or trustees may engage the employer's auditor, other outside auditors, in-house compliance personnel, or others to perform agreed upon procedures to test the completeness of employer contributions. The employer payroll procedures should be designed to test that all employees working for a contributing employer performing covered work ("covered work" is defined under the collective bargaining agreement) have been properly reported and that any subcontracting work performed on behalf of a contributing employer is also being reported. The auditor performing the payroll procedures will typically issue an agreed-upon procedures report in accordance with Statements on Standards for Attestation Engagements (SSAE) No. 4. Plan auditors should obtain a copy of the agreed-upon procedures report that describes the procedures performed on the participant data and the findings.

10.09 If the payroll procedures are performed by in-house compliance personnel, the plan's auditors should review the compliance procedures. If a multiemployer benefit plan does not have annual employer payroll procedures performed, or if the auditor does not believe that the procedures being performed are acceptable and if the auditor is unable to obtain the necessary assurance by other means, then the auditor would either issue a qualified or disclaim an opinion on the financial statements because of the limitation on the scope of the audit* or adjust and correct the internal auditor's payroll procedures to the point where the auditor can issue an unqualified opinion on the audited financial statements.

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* See SAS No. 58, as amended by SAS No. 79, paragraphs 22 through 26 and paragraphs 13.26 through 13.30 of this guide for further guidance.

Defined Benefit Plans

10.10 Contributions to a defined benefit plan ordinarily are determined on the basis of an actuarial valuation of the plan carried out by the plan actuary, using participant data received from the plan administrator or the employer company and using actuarial techniques. For multiemployer plans and certain other negotiated plans, contribution levels are normally specified in the plan instrument or collective bargaining agreement, and an actuarial valuation is used to compare accumulated contributions to date with accumulated plan benefits. SAS No. 73, paragraph 12, states, "The auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist, (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements." Accordingly, the auditor should satisfy himself or herself that the participant data provided to and used by the actuary were accurate and complete in all material respects.

10.11 In addition to the auditing procedures described in paragraphs 10.04 through 10.06 of this chapter, when auditing the financial statements of defined benefit plans that involve actuarial valuations, the auditor should consider applying auditing procedures that include—

a. Tracing information obtained during tests of participant data to the participant data given by the plan administrator to the actuary.

b. Testing the basic data used by the actuary in his or her calculations (for example, name, sex, birth date, hours worked, employment dates, dates of participation in plan, and salary) by tracing data from the actuary's report (if the data are shown in the report) or from a confirmation letter obtained from the actuary to the data furnished by the plan. This test would normally include a selection of individuals as well as summary totals (see paragraph 10.20*f*).

Defined Contribution Plans

10.12 For defined contribution plans, the types of participant data that should be tested will vary from plan to plan. The data tested generally should include—

a. Covered compensation of individual participants. IRS regulations generally require that the company contribution be allocated to participants on the basis of the ratio of their covered compensation to total covered compensation for all participants.

b. Individual participants' contributions to the plan.

c. Birth date, date of hire, and other demographic data that determine eligibility and vesting.

10.13 In addition to other uses, these data are used by the auditor to test the validity of terminations and the eligibility of individuals to participate in the plan. Examples of the auditor's procedures in which the data are used are—

a. Tracing individuals who have terminated to benefit payments or to benefits payable and, if forfeitures are involved, to the record of forfeited amounts.

b. For individuals who qualify for participation during the year and who elect to participate, evaluating whether the individuals have been properly included in the individual participant accounts.

10.14 The auditing procedures discussed in paragraphs 10.04 through 10.06 (including procedures relating to the use of the work of an actuary, if applicable) should also be applied to the data.

Health and Welfare Benefit Plans

10.15 The types of participant data that should be tested in the audit of the financial statements of a health and welfare benefit plan differ widely from plan to plan. In general, the data tested may include—

a. Payroll data, including salary or wage rate and hours worked.

b. Demographic data, including sex, birth date, date of hire, and number of dependents.

c. Claims history records maintained by the plan administrator.

10.16 The auditing procedures discussed in paragraphs 10.04 through 10.06 (including procedures relating to the use of the work of an actuary, if applicable) should also be applied to the data. The use of the data in evaluating eligibility and benefits is discussed in paragraph 9.03.

Plan Obligations

10.17 As discussed earlier in this chapter and in chapters 2, 3, and 4, the nature of plan benefit obligations and the methods of valuing and recording those obligations differ significantly among the three types of plans.

Defined Benefit Plans

10.18 The objective of auditing procedures applied to accumulated plan benefits is to provide the auditor with a reasonable basis for concluding whether the actuarial present value of accumulated plan benefits, components of those benefits, and amounts of changes in the actuarial present value of accumulated plan benefits are presented in conformity with FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. That objective is ordinarily accomplished by applying the auditing procedures described in paragraph 9.03 for benefit payments, paragraphs 10.04 through 10.11 for participant data, and paragraphs 10.21 through 10.26 for using the work of an actuary.

10.19 The actuarial valuation used to determine accumulated plan benefits in accordance with FASB Statement No. 35 is based on the benefit provisions of the plan and on participant data. For many defined benefit plans the participant data submitted to the actuary are current only as of the beginning of the plan year. The practice of preparing valuations as of the beginning of a plan year developed as a practical expedient to facilitate completion of the valuation on a timely basis. For financial reporting purposes, the information may be presented either as of the beginning or the end of the plan year; FASB Statement No. 35 states, however, that an end-of-year benefit information date is considered preferable.

10.20 In the event that an actuarial valuation has not been prepared as of the beginning or the end of the plan year, the plan administrator may nevertheless prepare financial statements using estimated accumulated benefit information as contemplated by FASB Statement No. 35. If the benefit information is so estimated, the auditor should assure himself or herself that the methods and assumptions used to estimate the accumulated benefit information are reasonable in the circumstances, and he or she should apply the procedures set forth in SAS No. 73.

Using the Work of an Actuary

10.21 The auditor's qualifications do not encompass actuarial science or the complexities of probability and longevity associated with life contingencies. The auditor may have a general awareness and understanding of actuarial concepts and practices; he or she does not, however, purport to act in the capacity of an actuary. The auditor, therefore, needs to follow the guidance of SAS No. 73 to obtain assurance regarding the work of an actuary on such matters as plan contributions (see chapter 8) and accumulated benefit valuations.[59]

10.22 An audit of plan financial statements requires cooperation and coordination between the auditor and the plan actuary. The auditor uses the work of an actuary as an audit procedure to obtain competent evidential matter; the auditor does not merely rely on the report of an actuary. Although the appropriateness and reasonableness of the methods and assumptions used, as well as their application, are within the expertise of the actuary, the auditor does not divide responsibility with the actuary for his or her opinion on the financial statements taken as a whole. Thus, the auditor should satisfy himself or herself as to the professional qualifications and reputation of the actuary, obtain an understanding of the actuary's methods and assumptions, test accounting data provided to the actuary, and consider whether the actuary's findings support the related representations in the financial statements. Ordinarily, the auditor would use the work of the actuary unless the auditing procedures lead him or her to believe that the findings were unreasonable in the circumstances. Sometimes it may be necessary for the auditor to obtain the services of an actuary other than the one who prepared the plan's actuarial valuation. This might occur when the plan actuary is related to the plan (see paragraph 10.23*d*) or when the auditor believes that the determinations made by the plan actuary are unreasonable.

10.23 With respect to the actuarial present value of accumulated plan benefits and changes therein (as well as contributions), the auditor, in following the guidance in SAS No. 73, should—

a. Obtain satisfaction regarding the professional qualifications of the actuary. If the actuary is not known to the auditor, the auditor should consider other factors that might provide information regarding the actuary's qualifications. Examples of factors to consider are whether the actuary is an "enrolled actuary" under ERISA sections 3041 and 3042; the actuary's membership in a recognized professional organization; and the opinion of other actuaries, whom the auditor knows to be qualified, regarding the actuary's professional qualifications.[60]

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[59] With regard to actuarial services provided a client by the auditor's firm, a related ethics ruling under the AICPA Rules of Conduct states: "Performance by a member of appraisal, valuation, or actuarial services, the results of which may be incorporated in the client's financial statements, would not impair a member's independence if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results of those services." (AICPA, *Professional Standards*, vol. 2, ET section 191.108, Ethics Ruling on Independence, Integrity and Objectivity No. 54, "Member Providing Appraisal, Valuation, or Actuarial Services.")

[60] There are no universal standards for establishing the professional qualifications of an actuary. Some actuaries specialize in or concentrate on pension matters; others confine their practice to life or property and liability insurance matters. Qualification, by education and experience, to practice in one of these areas does not necessarily prepare the actuary to practice in other areas.

b. Obtain an understanding of the actuary's objectives, scope of work, methods, and assumptions, and their consistency of application. For defined benefit plans the auditor should ascertain whether the method and assumptions used in the accumulated plan benefit information are in conformity with FASB Statement No. 35 and whether the funding method and assumptions are in accordance with ERISA.

c. Inquire whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations. For example, amounts contributed by employees and earnings thereon are properly included as vested benefits.

d. Inquire about the nature of any relationship the actuary may have with the plan or the employer company that may impair objectivity. This can usually be accomplished by asking the client to have the actuary describe in writing the relationship, if any, that may exist and that may appear to impair the objectivity of the actuary's work. The engagement of a consulting actuary to perform valuations on behalf of plan participants or a sponsor company ordinarily is not a relationship that would impair the objectivity of the actuary. If the actuary is related to the client, or if the auditor is unable to determine that the actuary has no relationship with the client that might impair objectivity, the auditor should consider performing additional auditing procedures regarding some or all of the actuary's methods and assumptions to determine that the findings are not unreasonable.

e. Test the reliability and completeness of the census data provided by the plan and used by the actuary in the actuarial valuation. These tests may be coordinated with the auditing procedures described in paragraphs 8.03 through 8.05 for plan contributions and 10.01 through 10.11 for participant data. In the event that data provided to the actuary are significantly incomplete, the auditor should inquire of the actuary in regard to the treatment of the incomplete data and should determine if the method used by the actuary to give effect to the missing data in his or her valuation is reasonable in the circumstances. This situation is most likely to occur in multiemployer plans.

f. Confirm aggregate participant data used in the actuarial valuation. (The auditor may wish to include this request as part of the audit inquiry letter to the plan's actuary.) In addition, the auditor may also wish to confirm information related to selected individual participants that is part of the aggregate amounts.

10.24 The auditor should ask the plan administrator to send a letter to the plan's actuary requesting that the actuary (*a*) provide the auditor with a copy of the actuarial report, Schedule B of Form 5500, or comparable information or (*b*) confirm to the auditor the actuarial information that has already been obtained from the plan in connection with the audit.

10.25 An illustration of a letter to the plan's actuary requesting a copy of the actuary's report or other information on the plan appears as Exhibit 10.39. In situations in which the auditor also audits the financial statements of the sponsor company, he or she should consider combining the request for this information with a request for information necessary for compliance with FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.*

10.26 An illustration of a letter to the plan's actuary requesting confirmation of information taken from the actuary's report or the plan's or the sponsor company's records appears as Exhibit 10.40.

Defined Contribution Plans

10.27 The net assets available for benefits for defined contribution plans are normally allocated to individual participant accounts according to procedures set forth in the plan instrument or in a collective bargaining agreement. In some cases the plan instrument may even specify the allocation of individual plan assets.

10.28 Plan assets of defined contribution pension plans are generally to be presented at their fair value (see paragraphs 3.14 and 3.17 for special provisions concerning the valuation of insurance contracts and the valuation of fully benefit-responsive-contracts). Such plans typically permit periodic contributions, withdrawals, loans and changes in investment elections. Transactions can be executed by the plan participant at varying frequencies depending upon the plan's provisions; however, plans that permit transactions on a daily basis are becoming predominant. Thus, the determination of the value of plan assets on the dates throughout the year in which the plan permits transactions is important. Where an investment option in a defined contribution plan contains "hard to price" investments such as limited partnerships, periodic valuation is more difficult, but nonetheless important. Failure to properly value plan assets on the date of a participant directed transaction can result in such transactions being executed at inappropriate amounts and consequently either an understatement or overstatement of plan assets and distributions.

10.29 The objective of auditing procedures applied to individual participant accounts of defined contribution plans is to provide the auditor with a reasonable basis for concluding—

a. Whether net assets have been allocated to the individual participant accounts in accordance with the plan instrument.[61]

b. Whether the sum of the participant accounts reconciles with the total net assets available for plan benefits.

c. Whether participant transactions are authorized and have been executed at the proper amount in the proper period.

10.30 Procedures that the auditor ordinarily should apply to individual participant accounts include—

a. Reviewing pertinent sections of the plan instrument or collective bargaining agreement to obtain an understanding of how allocations are to be made.

b. Testing the allocation of income or loss, appreciation or depreciation in value of investments, administrative expenses, and amounts forfeited for selected accounts.

c. Testing the allocation of the employer's contribution.

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[61] The effects of misallocation of assets should be considered in relation to the financial statements as a whole rather than in relation to individual accounts.

d. For plans with participant contributions, determining whether individual contributions are being credited to the proper participant accounts and to the investment medium selected by the participant, if applicable. Where participants make contribution or investment elections by telephone or electronic means (such as the Internet or Intranet), consider confirming contribution percentage and source (pre-tax/post-tax) and investment election directly with the participant or compare to a transaction report, if one is maintained. Determine that contributions are properly classified and invested according to the participants' investment election.

e. Determining whether the sum of individual accounts reconciles with the total net assets available for benefits.

f. Testing of a net asset value per share/unit at which participant transactions are executed. (This may be addressed in the SAS No. 70 report of the recordkeeper for the plan's investment.)

Depending on the existing internal control and the results of other auditing procedures, the auditor may also wish to confirm contributions and other pertinent information directly with participants.

Health and Welfare Benefit Plans

10.31 Plan obligations for health and welfare benefit plans are paid out of a fund of accumulated contributions and income (a self-funded plan), are provided through insurance purchased by the plan from an insurance company (an insured plan), or are provided through some combination of the two. Insured plans may involve several funding arrangements including (*a*) fully insured, pooled; (*b*) fully insured, experience-rated; (*c*) minimum premium plans; and (*d*) stop-loss arrangements. Insured plans may also encompass a continuum of products including (*a*) basic indemnity plans; (*b*) preferred provider plans; (*c*) point-of-service plans (also known as multi-option); and (*d*) health maintenance organization (HMO) plans. Self-funded plans may take several forms including (*a*) Administrative Service Only (ASO) arrangements; (*b*) Claims Service Only (CSO) arrangements; and (*c*) unlimited retro-premium arrangements. This significant variety of funding, product, and service arrangements increases the inherent risk in identifying and valuing the benefit obligations of the plan. For example, in an insured plan, obligations for claims reported but not paid and obligations for claims incurred but not reported will be paid, *in whole or in part* (depending on the funding and/or product arrangements) by the insurance company and, therefore, to such extent would not appear as obligations in the financial statements of the plan. Alternatively, a self-funded plan should include in its financial statements information regarding the plan's obligations for each of these types of claims. With regard to plan obligations, the auditor should read all relevant provisions of the plan instrument and underlying contracts and determine that they are properly accounted for.

10.32 Procedures that auditors may apply to individual participant enrollment and contributions include—

a. Reviewing pertinent sections of the plan instrument or collective bargaining agreement to obtain an understanding of eligibility and contribution provisions.

b. For individuals qualifying for participation during the year and who elect to participate, evaluating whether the individuals have been properly included in the plan records.

c. For plans that require participant contributions, determining that the proper contribution is being made based upon the participant's elections. Where participants enroll by telephone or electronic means (such as the Internet or Intranet) confirm plan elections directly with the participant.

10.33 For insured plans, the auditor should determine whether the proper dollar amount of premiums has been remitted to the insurance company and whether any obligation for unpaid insurance premiums has been properly recorded. Insurance premium payments are generally determined from the participants' eligibility records and the premium rates in the insurance contract. In testing the premium payments and related obligation, procedures that should be considered include—

a. Comparing the number of eligible participants, as shown by the eligibility records, to the premium computation and tracing the applicable premium rates to the insurance contract.

b. Tracing participants listed in the premium computation list to the eligibility records.

c. Comparing premiums paid, including subsequent payments, and investigating the reasons for significant changes.

d. Requesting direct confirmation from the insurance company of the total amount of premiums paid during the year, premiums payable to the insurance company, and other obligations and assets of the plan at year-end.

Any premium payable to the insurance company should be recorded as a benefit obligation. Insurance contracts should be reviewed to determine that the obligation is in accordance with the contract provisions.

10.34 In self-funded plans, claims reported to the plan administrator but not paid are obligations of the plan. In testing the obligation for claims reported but not paid, procedures that should be considered include—

a. Comparing individual claims with the trial balance, and reviewing the nature of the claim and the documentary support.

b. Reviewing payments made after the date of the financial statements to determine whether all claims reported have been properly included in the trial balance.

c. Performing a search of open claim files, an option the auditor may choose, depending on the timing of the audit.

10.35 As of the date of the financial statements, there will be certain claims incurred but not yet reported to the plan, and some of these may not be reported for an extended period of time. Claims of this nature cannot be determined on an individual basis, but the aggregate amount of such claims should be subject to reasonable estimation on the basis of past loss experience and actuarial determination (see paragraph 10.37). If information necessary to make this estimate is not available, the auditor should consider the possible effect on his or her report.

10.36 The eligibility rules for many plans provide for the accumulation of eligibility credits for participants. The obligation arising from eligibility credits is generally determined by applying current insurance premium rates to accumulated eligibility credits or, in the case of a self-funded plan, by applying the average cost of benefits per eligible participant. The accrued obligation should be reviewed and tested for adequacy and reasonableness. Such tests should include a comparison of the employer's contributions with the participants' eligibility records, a test of the arithmetical accuracy of the accumulated credits, and a review of the overall computation of the estimated obligation.

10.37 Many health and welfare benefit plans provide benefits that require an actuarial determination of the plan's benefit obligation. An actuary may also be used to determine contribution rates. If the plan requires the services of an actuary in determining amounts in the financial statements, the auditor should apply the procedures discussed in paragraphs 10.21 through 10.26 for using the work of an actuary.

10.38 The types of information the auditor should consider confirming with the actuary include—

a. A description of participant groups covered.

b. A brief, general description of the characteristics of the plan used in the actuary's calculations, including, but not limited to, benefit provisions.

c. The number of employees in the actuary's valuation and the number of participants and beneficiaries who are active, terminated with vested benefits, or retired under the plan.

d. The present value of the plan's benefit obligations. (Be careful that the actuarially calculated benefit obligations do not include claims included elsewhere in the statement of net assets. Consider also whether all claims are properly included.)

e. The dates of the valuation of the benefit obligations and of the census data used. (If the date of the census data used is other than the plan year-end, the actuary should be asked to indicate the basis for projecting the data to the year-end.)

f. Descriptions of the principal assumptions and methods used in determining the present value of plan obligations and of any changes in assumptions or methods (for example, interest rates), and the effect of any changes.

g. The significant effects (either individually or in the aggregate) on the current year of the changes resulting from plan amendments.

h. Knowledge of an intent on the part of the employer (sponsor company) to fully or partially terminate the plan.

i. The amount of unbilled or unpaid actuary's fees applicable to the plan's year-end and payable by the plan.

Exhibit

10.39

Illustrative Letter to Plan Actuary

In connection with an audit of the financial statements of XYZ Pension Plan [*date of statements*], please furnish our auditors [*name and address*], the information described below as of [*the more recent benefit information date, either the date of the plan year-end or the date of beginning of plan year*]. For your convenience, you may supply in response to these requests pertinent sections, properly signed and dated, of your actuarial report or Schedule B of Form 5500, if available and if the requested information is contained therein.

a. Please indicate the actuarial present value of accumulated plan benefits as defined in FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, classified as follows:

1. Vested benefits of participants and beneficiaries currently receiving payments	$________
2. Other vested benefits	$________
3. Nonvested benefits	$________
4. Total	$________

b. The date of the above valuation of accumulated plan benefits is ____.

c. Describe the principal assumptions used in determining the actuarial present value of accumulated plan benefits.

d. Please indicate the minimum annual contribution, including the use of any credit balances in the funding standard account available to offset present or future contributions under ERISA and the actuarial cost method being used; a description of the actuarial assumptions used in computing the funding standard account; and the aggregate effect of any change in the method or assumption(s). Also, indicate whether the alternative funding standard account was elected and whether the full-funding limitation is applicable.

e. Briefly describe the employee group covered.

f. Please provide the following:

1. A brief general description of the benefit provisions of the plan used in the actuarial calculation

2. A description of any benefits, as prescribed by FASB Statement No. 35, not included in the accumulated plan benefits valuation and the reason therefore

3. The effective date of the last plan amendment included in this valuation

g. Please provide the following information relating to the employee census data used in performing the actuarial valuation:

1. The date as of which the census data were collected is ______.

Compensation Participant	Number of persons	Compensation (if applicable)
Currently receiving payments	______	______
Active with vested benefits	______	______
Terminated with deferred vested benefits	______	______
Active without vested benefits	______	______
Other (describe)	______	______
Total	______	______

Note: If information is not available for each of the above categories, indicate which categories have been grouped. Please describe any group or groups of participants not included in the above information.

2. Information for specific individuals contained in the census:

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

[*Note to auditor: The auditor should select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have selected certain census data from the actuary's files to compare with the employer's records.*]

h. Describe, if significant (either individually or in the aggregate), the effects of the following factors on the change in the actuarial present value of accumulated plan benefits from the preceding to the current benefit information date. (Effects that are individually significant should be separately identified.)

1. Plan amendments
2. Changes in the nature of the plan (for example, a plan spin-off or a merger with another plan)
3. Changes in actuarial assumptions

i. Describe, for the current year, the effects of the following on changes in the present value of accumulated plan benefits:

1. Increase in benefits accumulated
2. Increase due to the passage of time
3. Benefits paid

[*Note to auditor: Item (i) generally applies only if the change in actuarial information is being presented in statement format.*]

j. If an accumulated funding deficiency exists, the amount necessary to reduce the deficiency to zero under ERISA is $_____.

k. Have you been notified of a decision by the sponsor company to fully or partially terminate the plan? If so, please describe the effect on the plan.

l. Please describe the nature of the relationship, if any, that you may have with the plan or the sponsor company and that may appear to impair the objectivity of your work.

m. What is the amount of the unbilled and/or unpaid actuarial or other fees due your firm applicable to the plan year-end and payable by the plan?

n. Please supply any additional information that you believe is necessary.

Your prompt attention to this request will be appreciated.

Very truly yours,

____

Plan Administrator

Exhibit
10.40

Illustrative Letter to Plan Actuary

In connection with their audit of our financial statements as of [*date of plan year-end*], our auditors [*name and address*], have requested that you confirm to them the following information as of [*benefit information date*] with respect to our defined benefit pension plan described in your report dated ______.

[List of information to be confirmed]

Please confirm the above information by signing the enclosed copy of this letter in the space provided, and return it directly to our auditors. If the above information is not correct, please inform our auditors directly and, if possible, send them full details of the differences.

Your prompt attention to this request will be appreciated.

Very truly yours,

____
Plan Administrator

The above information is correct except as noted below.

____
(Signature of Actuary)

Chapter 11

Party in Interest Transactions

11.01 Section 3(14) of ERISA defines a "party in interest" to include fiduciaries or employees of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee organization whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee association, or relatives of such persons just listed. Although not identical, ERISA defines "parties in interest" in much the same way as FASB Statement No. 57, *Related Party Disclosures*, defines the term *related parties*.

11.02 Certain transactions between a plan and a party in interest are generally prohibited under section 406(a) of ERISA:

- A sale, exchange, or lease of property
- A loan or other extension of credit
- The furnishing of goods, services, or facilities
- A transfer of plan assets to a party in interest for the use or benefit of a party in interest
- An acquisition of employer securities or real property in violation of the 10-percent limitation.

Additional information regarding prohibited transactions under ERISA is found in paragraphs A.83 through A.88.

11.03 There are certain exceptions dealing with party in interest transactions that do not prevent a plan fiduciary from receiving reasonable compensation for services to a plan, or receiving benefits from a plan as a participant or beneficiary, as long as such benefits are in accordance with the terms of a plan as applied to all other participants and beneficiaries. In addition, payments to parties in interest for reasonable compensation for office space and legal, accounting, and other services necessary for the operation of a plan are permitted if certain conditions are met. For example, while transactions with a trustee affiliate also serving as a fund advisor/manager would generally be prohibited transactions, the DOL has issued Prohibited Transaction Exemptions (PTE) (Nos. 84-24, 80-51, 78-19, 84-14, and 77-4) relating to these types of transactions. Therefore, they are considered to be *exempt* party in interest transactions and would not have to be reported on the Form 5500 or in the related supplemental schedules. However, in accordance with FASB Statement No. 57, related party transactions should be disclosed if they are material to the financial statements.

11.04 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related-party or party in interest transactions will be discovered. Nevertheless, during the course of his or her audit, the auditor should be aware of the possible existence of party in interest and material related-party transactions that could affect the financial statements or for which DOL Reporting Regulations (see appendix A) and FASB Statement No. 57 require disclosure. Many of the procedures outlined in the following paragraphs are normally performed in an audit in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that party in interest transactions exist. Other audit procedures set forth in this section are specifically directed to party in interest transactions.

11.05 The existence of certain party in interest relationships, such as plan-sponsor, may be clearly evident. Determining the existence of other parties in interest requires the application of specific audit procedures, which may include the following:

a. Evaluate the plan administrator's procedures for identifying and properly accounting and reporting for party in interest transactions.

b. Request from appropriate personnel the names of all parties in interest and inquire whether there were any transactions with these parties during the period.

c. Review filings (for example, Forms 5500 and LM-2) by the reporting entity with the DOL and other regulatory agencies for the names of parties in interest.

d. Review prior years' working papers for the names of known parties in interest.

e. Inquire of the predecessor plan auditor, if applicable, concerning his or her knowledge of existing relationships and the extent of management involvement with parties in interest.

f. Inquire of the plan administrator whether any prohibited transactions have been identified as a result of past IRS or other governmental examinations.

11.06 The following procedures are intended to provide guidance for identifying transactions with known parties in interest and for identifying transactions that may be indicative of the existence of previously undetermined party in interest relationships:

a. Provide audit personnel performing segments of the audit with the names of known parties in interest so that they may become aware of transactions with such parties during the audit.

b. Review the minutes of the meetings of the board of trustees of the plan and executive or operating committees for information about transactions authorized or discussed at their meetings.

c. Review correspondence from and material filed with the DOL and other regulatory agencies for information about transactions with parties in interest.

d. Review conflict-of-interests statements obtained by the plan from its officials.[62]

e. Review the extent and nature of business transacted with the plan's major investees, suppliers, borrowers, lessees, and lenders for indications of previously undisclosed relationships.

f. Consider whether transactions are occurring but are not being given accounting recognition, such as receiving or providing accounting management or other services at no charge or a major stockholder of the plan-sponsor absorbing plan expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

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[62] Conflict-of-interests statements are intended to provide plan officials with information about the existence or nonexistence of relationships between the reporting persons and parties with whom the plan transacts business.

h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by parties in interest.

i. Review invoices from law firms that have performed regular or special services for the plan for indications of the existence of parties in interest or party in interest transactions.

j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

11.07 The auditor should place emphasis on testing material transactions with known parties in interest. After identifying party in interest transactions, the auditor should apply the procedures he or she considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

a. Obtain an understanding of the business purpose of the transaction.[63]

b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents.

c. Determine whether the transaction has been approved by the board of trustees or other appropriate officials.

d. Test for reasonableness the compilation of amounts to be disclosed or considered for disclosure.

e. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

11.08 When necessary to fully understand a particular party in interest transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered:[64]

a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.

b. Inspect evidence in possession of the other party or parties to the transaction.

c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.

d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.

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[63] Until he or she understands the business sense of material transactions, the auditor cannot complete his or her audit. If the auditor lacks sufficient specialized knowledge to understand a particular transaction, he or she should consult with persons who do have the requisite knowledge.

[64] Arrangements for certain procedures should be made or approved in advance by appropriate plan officials.

e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

Prohibited Transactions

11.09 In accordance with the provisions of SAS No. 54, *Illegal Acts by Clients,* the auditor also should be alert to party in interest transactions that may be prohibited by ERISA. When the auditor becomes aware of information concerning a possible prohibited party in interest transaction, the auditor should obtain an understanding of the nature of the transaction, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of plan management at a level above those involved, if possible. If management does not provide satisfactory information that the transaction is not prohibited, the auditor should—

a. Consult with the client's legal counsel or other specialists about the application of ERISA to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with the client's legal counsel should be made by the client.

b. If necessary, apply procedures such as those described in paragraphs 11.07 and 11.08 to obtain further understanding of the nature of the transaction.

11.10 If the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that a party in interest transaction has resulted in the occurrence of an illegal act, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

11.11 The auditor should consider the effect of the prohibited transaction on the amounts presented in financial statements including contingent monetary effects, such as fines, penalties, and damages. Because a plan fiduciary is liable to make good on losses to the plan resulting from a breach of fiduciary duty and to restore to the plan any profits that the fiduciary made through the use of the plan's assets, prohibited transactions can give rise to significant receivables. Any receivable to be recorded should include an allowance for estimated uncollectible amounts. Contingencies arising from prohibited transactions may also need to be disclosed in accordance with the requirements of FASB Statement No. 5, *Accounting for Contingencies.*

11.12 The auditor should evaluate the adequacy of disclosure in the financial statements and required supplementary schedules of the potential effects of prohibited transactions on the plan's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, that information should be considered for disclosure.

Implications for Audit

11.13 The auditor should consider the implications of prohibited transactions in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular prohibited transactions will depend on the relationship of the perpetration and concealment, if any, of the transactions to specific control procedures and the level of management or employees involved.

Effect on the Auditor's Report

11.14 Both ERISA and generally accepted auditing standards require that the auditor's report on financial statements included in an annual report filed with the DOL cover the information in the required supplementary schedules—including the schedule of party in interest transactions—presented along with the basic financial statements. Chapter 13 includes a discussion of auditor's reports on financial statements and information in supplementary schedules as well as examples of such reports.

11.15 ERISA requires that all transactions with parties in interest (excluding any transactions exempted from prohibited transaction rules) be disclosed in the supplementary schedule without regard to their materiality. If the auditor concludes that the plan has entered into a prohibited transaction with a party in interest, and the transaction has not been properly disclosed in the required supplementary schedule, the auditor should (*a*) express a qualified opinion or an adverse opinion on the supplementary schedule if the transaction is material to the financial statements or (*b*) modify his or her report on the supplementary schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements (see paragraph 13.18 for examples of reports). If the client refuses to accept the auditor's report as modified, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to the plan administrator or board of trustees.

Communication With Responsible Parties

11.16 The auditor should assure himself or herself that the plan administrator, or others with equivalent authority and responsibility, is adequately informed with respect to prohibited transactions and other illegal acts that come to the auditor's attention (see paragraph 6.18 for a discussion of individuals with the level of authority and responsibility equivalent to an audit committee). The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the plan administrator on the nature of such matters to be communicated.

Chapter 12
Other Auditing Considerations

Plan Tax Status

12.01 A trust established under an employee benefit pension plan ordinarily is qualified under the Internal Revenue Code (IRC) as exempt from federal income taxes. The objective of auditing procedures applied with respect to the tax status of a plan is to permit the auditor to consider—

a. Whether the trust is qualified under the IRC as being exempt from federal income taxes and whether transactions or events have occurred that might affect the plan's qualified status.[65]

b. Whether asserted and unasserted claims and assessments affecting plan assets resulting from the loss of tax exemption have been properly recorded or disclosed in conformity with generally accepted accounting principles.

12.02 The financial statements of an employee benefit plan generally have no accrued income tax liability or provision for income tax expense. Plans must be designed and operated in accordance with IRC requirements in order to maintain their qualified status. The existence of a determination letter does not in and of itself serve as evidence that the plan is qualified. Determination letters provide evidence that the plan is designed in accordance with applicable IRC requirements. However, qualified plans must comply with certain operating tests in order to be tax qualified (for example, coverage, discrimination, and maximum benefit limitation tests). Nevertheless, the auditor of an employee benefit plan should be aware of the possibility that violations of tax laws and regulations may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred (see SAS No. 54, *Illegal Acts by Clients*, paragraph 7). The auditor is also expected to inquire of, and obtain representations from, management concerning compliance with the laws and regulations and the prevention of violations that may cause disqualification. As noted in paragraph 5.09, the auditor should possess sufficient knowledge of matters affecting employee benefit plans, including applicable sections of the IRC.

12.03 The auditing procedures applied in an audit of a plan's tax status ordinarily are—

a. Reviewing the IRS tax determination letter or an opinion letter from the plan's qualified tax counsel. If the plan has been amended, review any new rulings issued by the IRS regarding the modified plan instru-

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[65] Note that ERISA requires disclosure of "information concerning whether or not a tax ruling or determination letter has been obtained." Generally accepted accounting principles (for example, FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended) require disclosure of the federal income tax status of a plan only if a favorable tax determination has not been obtained or maintained.

ment. If the plan is amended subsequent to the receipt of the latest determination letter, appropriate disclosure should be made, for example:

The plan obtained its latest determination letter on [*date*], in which the Internal Revenue Service stated that the plan, as then designed, was in compliance with the applicable requirements of the Internal Revenue Code. The plan has been amended since receiving the determination letter. However, the plan administrator and the plan's tax counsel believe that the plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code. Therefore, no provision for income taxes has been included in the plan's financial statements.

If a determination letter has not been requested and an opinion letter from the plan's tax counsel is not available, the auditor may wish to review those aspects of the plan document relevant to the determination of its tax-exempt status.

For health and welfare plans, the auditor should review the IRS tax determination letter for the trust, if applicable. VEBAs established since 1984 are required to request exempt status from the IRS using Form 1024. VEBAs established before 1984 do not need a determination letter, if they had previously formally declared exempt status through the filing of Form 990 with the IRS. If the trust has been amended since the original determination letter, the Form 990 procedures require disclosure of the changes; no new application for determination is required.*

b. Inquiring of the plan administrator, trustee, or other appropriate plan representative about the plan's or trust's operations or changes in plan or trust design that may cause the plan or trust to lose its tax-exempt status. Examples of IRC requirements with which a plan must comply in order to maintain its tax exempt status include the following:

- Minimum coverage test (retirement plans only)
- Minimum participation tests (retirement plans only)
- Nondiscrimination test (both retirement and welfare plans)
- Average deferral and contribution percentage limits (401(k) plans only)
- Annual additions limitation (generally retirement plans only, but funded health plans can reduce the allowable benefit for key employees)
- Top heavy test (retirement plans only)
- Exclusive benefit rule (both retirement and welfare plans)

c. Reviewing the results of auditing procedures applied in other areas of the audit and considering the findings in relation to tax qualification requirements such as those noted in *b* above.

As a result of the procedures performed in *b* and *c* above, the auditor may become aware of possible violations of tax laws and regulations that could adversely affect the plan's tax status. In those situations, the auditor should consider the effect on the financial statements as well as implications for other aspects of the audit as described in SAS No. 54.

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* It is the trust that is required to get a determination letter not the plan itself.

Commitments and Contingencies

12.04 Procedures that the auditor ordinarily should apply in connection with the commitments and contingencies of an employee benefit plan include—

a. Discussing possible areas of commitments and contingencies with the sponsoring employer, plan administrator, or other parties performing the plan's management functions.

b. Reviewing minutes of various committees of the plan during and subsequent to the period being audited for discussion of possible contingent liabilities or commitments.

c. Analyzing legal expenses for the period and reviewing invoices and statements from legal counsel for indications of possible contingencies. The legal expenses of a single employer plan may be paid directly by the employer, in which case the auditor should consider reviewing those expenses.

d. Obtaining a representation letter from the appropriate persons, normally the plan's administrator or other parties performing the plan's management function (see SAS No. 85, *Management Representations,** and paragraph 12.18 of this guide).

e. Inquiring as to any audit or investigation that the DOL, the IRS, or other regulatory agency has made of the plan's activities or filings since the last audit (such reviews might arise, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption). Obtain and review for financial statement implications any report of an audit or investigation not reviewed as part of the audit planning process, (see paragraph 5.16(*e*)) including the effect of transactions noted therein that give rise to potential receivables arising from breaches of fiduciary duties or prohibited transactions. Consider whether this information obtained from the inquiry should be included in the representation letter.

12.05 An audit inquiry letter to the plan's lawyer is the auditor's primary means of corroborating the information provided by plan management concerning litigation, claims, and assessments (see SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*). The American Bar Association (ABA) has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which is set forth in Exhibit II to SAS No. 12. Audit inquiries to plan lawyers should be made in the context of the ABA/AICPA understanding, as discussed in SAS No. 12.

12.06 The auditor should request plan management to send an audit inquiry letter to those lawyers who have been consulted regarding litigation,

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* In December 1999 the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which amends SAS No. 85 to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. This amendment is effective for audits of financial statements for periods beginning on or after December 15, 1999 with early adoption permitted.

claims, assessments, and qualification matters relating to the plan. The matters that ordinarily should be covered by the audit inquiry letter are described in SAS No. 12, paragraph 9, and include a list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments or unasserted claims with respect to which the lawyer has been engaged and to which he or she has devoted substantial attention on behalf of the plan in the form of legal consultation or representation. The matters described in *a* through *g* below should be included in the "pending or threatened litigation" or "unasserted claims and assessments" sections of the attorney's letter. They should not be listed as "other matters" and the letter should refer to specific matters disclosed by management, or should expressly state that management has advised the auditor that there are no such matters.

a. Breach of fiduciary responsibilities.

b. Prohibited party in interest transactions and other transactions prohibited by ERISA. (Parties in interest are defined in ERISA section 3(14) and regulations under that section. See also chapter 11.)

c. Loans or leases in default and reportable to the DOL.

d. Events reportable to the PBGC.

e. Events that may jeopardize the plan's tax qualification status.

f. Legal actions brought against the plan on behalf of plan participants and beneficiaries.

g. Review or inquiry by the DOL, the IRS, or other regulatory agency of the plan's activities or filings since the last audit. (A review or inquiry might arise, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption.)

Cash Balances

12.07 Cash balances of employee benefit plans tend to be very small, representing residual amounts not otherwise invested. When cash balances are held in trust under a trust agreement or under an insurance contract, confirmation of the balance normally is adequate. For a plan that maintains and controls cash accounts that are independent from the trust accounts or insurance contracts, auditing procedures such as those customarily used in audits of other entities are normally appropriate.

Administrative Expenses

12.08 The objective of auditing procedures applied to administrative expenses is to provide the auditor with a reasonable basis for concluding whether those expenses are in accordance with agreements, are properly classified, and are recorded in appropriate amounts and periods.

12.09 The audit of administrative expenses ordinarily should include—

a. Analyzing the account and examining supporting invoices, documents, and computations.

b. Reviewing the terms of the plan instrument and the minutes of the board of trustees or administrative committee to determine that administrative expenses were properly authorized.

c. If the plan employs a contract administrator, reviewing the contract and testing to ascertain that the services contracted for were performed and that payments were in accordance with the terms of the contract.

d. If one office functions as a service organization for several plans and administrative expenses are allocated because they are not directly associated with a specific plan, reviewing the allocation to determine that it is appropriate and determining that the method of allocation selected was approved by the board of trustees or administrative committee.

e. Determining that fees charged by trustees, investment advisors, and others are in accordance with the respective agreements.

Subsequent Events

12.10 Guidance on the auditor's procedures relating to subsequent events is provided in SAS No. 1, section 560, *Subsequent Events*. The following auditing procedures ordinarily should be applied for all employee benefit plans. The list is not all-inclusive and should be modified to suit the circumstances of a specific engagement.

a. Reviewing minutes of committee meetings held through the completion of the fieldwork.

b. Obtaining supplemental legal representations if there is a significant period between the date of the plan's legal counsel's response and the date of completion of fieldwork.

c. Obtaining the plan's interim financial statements for a period subsequent to the audit date, if they are available, comparing them with the financial statements being audited, and investigating any unusual fluctuations.

d. Inquiring of and discussing with the plan administrator or other parties performing the plan's management function—

- Abnormal disposal or purchase of investments since year-end.
- Amendments to plan and trust instruments and insurance contracts.
- Matters involving unusual terminations of participants, such as termination arising from a sale of a division or layoffs.
- Changes in plan commitments or contingent liabilities.
- Any review or inquiry by the DOL, the IRS, or other regulatory agency of the plan's activities or filings since the last audit (a review or inquiry might arise, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption).

Plan Mergers

12.11 Company mergers and acquisitions, terminations of defined benefit pension plans, or other events may result in employee benefit plan mergers. The auditing procedures for a merged plan should provide the auditor with reasonable assurance that net assets available for benefits and plan obligations have been properly transferred to the successor plan. Procedures the auditor may wish to apply regarding plan mergers are as follows:

Defined Contribution Pension and Health & Welfare Benefit Plans:

— Reconciling net assets available for benefits per the trustee (custodian) to the recordkeeper immediately prior and subsequent to the merger.

— Comparing selected participant accounts immediately prior and subsequent to the merger to determine that accounts were transferred properly.

— Testing transfers of assets from the former trustee (custodian) to the current trustee (custodian).

— For multi-employer plans, testing that the contributions are allocated to the proper plan.

Defined Benefit Pension and Health & Welfare Benefit Plans:

— Testing selected employee census data immediately prior and subsequent to the merger to determine that employees affected by the merger have been properly included in the data.

— Reviewing actuarial report to determine that the effect of the merger on the plan's benefit obligation is properly disclosed in the statement of changes in accumulated benefits.

— Testing the transfer of assets from the former trustee (custodian) to the current trustee (custodian).

— For multi-employer plans, testing that the benefits are charged to the proper plan.

12.12 Because the effective date of a merger, according to the relevant plan merger documents, often is prior to the actual transfer date of the related plan assets, confusion exists as to what the last reporting date is for Form 5500 and financial statement purposes.

12.13 Procedures the auditors may wish to apply to determine the effective date of the merger include review of plan documents, amendments, minutes of plan meetings, correspondence with service provider, and other pertinent plan information; and reviewing the transfer date of assets from the former trustee (custodian) to the current trustee (custodian).

12.14 Auditors need to use judgment in each merger situation based on the procedures described above to determine the proper merger date for Form 5500 and financial statement purposes. Once the proper merger date is determined, auditors should be aware that the final Form 5500 is required to be filed seven months after that merger date.

Terminating Plans

12.15 The procedures for auditing a terminating plan should provide the auditor with a reasonable basis for concluding that:

a. Final termination payments are in accordance with the plan provisions, related documents and applicable regulations.

b. The payments are made only to or on behalf of persons entitled to them.

c. Transactions are recorded in the proper account, amount, and period.

d. Any plan asset reversions to the plan sponsor, if applicable, are in accordance with the plan provisions, related documents and applicable regulations.

See chapter 9, *Auditing Benefit Payments*. The auditor may consider increasing the extent of benefit payment testing during the period the termination benefits are paid. Also see paragraphs 2.40–2.44, 3.46–3.49, and 4.71–4.73 for accounting and reporting for a terminating plan.

12.16 Upon full or partial termination of a plan, affected participants become fully vested in accrued benefits at the termination date. A partial termination can occur if approximately 20 percent or more of plan participants are terminated by the plan sponsor as a result of an action, such as a plant closure, a decision to downsize, or the termination of a product line. The reduction can accumulate over one or more plan years and still be classified as a partial termination. Judgment is required to determine whether a partial termination has occurred. The auditor should consider consulting the Internal Revenue Service or qualified legal counsel if questions arise regarding the occurrence of a partial plan termination. Consideration also should be given to determine that terminated participants received their fully vested benefits and that there were no forfeited amounts.

Changes in Service Providers

12.17 Changing service providers (recordkeeper, trustee, and custodian, etc.) is fairly common for employee benefit plans. The auditor may want to consider the following procedures when a plan changes service providers:

- Obtain an understanding of the control environment for predecessor and successor service providers.
- Test transaction processing for predecessor and successor service providers during the year.
- For a change in defined contribution pension plan recordkeepers, agree the sum of the participant accounts per the predecessor recordkeeper prior to the change to the sum recorded by the successor recordkeeper immediately after the change. Select individual participant accounts immediately prior and subsequent to the change to ensure all account information was properly recorded by the successor recordkeeper.
- For a change in trustee or custodian, reconcile assets transferred from predecessor trustee or custodian to successor trustee or custodian. (If a defined contribution pension plan changes trustees or custodians and recordkeepers simultaneously, reconcile the sum of the participant accounts to the net assets per the trustee or custodian immediately prior and subsequent to the change.)

Changes in Actuaries

12.17a Employers may change the employee benefit plan's actuary. Before commencing the valuation for the current year, the new actuary usually attempts to replicate the former actuary's last valuation to ensure a consistent understanding of the plan provisions and their effects on the valuation. Paragraphs 10.21 through 10.26 provide audit guidance when using the work of an actuary. It is not unusual, after a change in actuary, that certain demographic assumptions, such as mortality, will change. In that case, the auditor should ascertain the reasonableness of the new assumption(s) and their conformity with FASB Statements No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and ERISA, as appropriate.

Plan Representations

12.18 The auditor should obtain certain written representations from appropriate persons, normally the plan's administrator or other parties performing the plan's management function for all financial statements and periods covered by the auditor's report (see SAS No. 85*). In addition to the representations included in the illustrative management representation letter in Exhibit 12-1, the representation letter should include, as applicable, representations regarding:

a. Whether financial circumstances are strained, with disclosure of management's intentions and the plan's ability to continue as a going concern.**

b. Whether the possibility exists that the value of specific significant long-lived assets may be impaired.**

c. Whether the work of a specialist has been used by the plan.**

d. Whether receivables have been recorded in the financial statements.**

e. Whether plan management has apprised the auditor of all communications, whether written or oral, with regulatory agencies concerning the operation of the plan.

f. Management's intention to not terminate benefit responsive investment contracts.

g. The impact of new accounting standards.

h. The adequacy of all allowances for receivables.

i. The information contained in the notes to the financial statements when the notes are "in the opinion of plan management" (or plan sponsor).

12.19 According to SAS No. 85,* if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified. Management's refusal to furnish written representations constitutes a scope limitation sufficient to preclude an unqualified opinion (see "Scope Limitations" section of SAS No. 58, *Reports on Audited Financial Statements*).

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* In December 1999 the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which amends SAS No. 85 to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. This amendment is effective for audits of financial statements for periods beginning on or after December 15, 1999 with early adoption permitted.

** See appendix B of SAS No. 85 for sample wording of this representation.

Exhibit 12-1*

*Following is an illustrative management representation letter for a full-scope defined benefit pension plan audit engagement, in accordance with SAS No. 85. This letter should be tailored to the specific type of plan being audited (e.g., defined contribution or health and welfare pension plans).*** *This letter may not contain all matters that pertain to the engagement and therefore should be modified, as appropriate, for the individual circumstances of each engagement, including if the engagement is for other than a full scope audit.**** *This letter should also be modified for special circumstances, such as plan mergers or terminations.*

[*Date*]

To [*Independent Auditor*]

We are providing this letter in connection with your audits of the financial statements and supplemental schedules of Sample Company Employee Benefit Plan (the Plan) as of December 31, 19X1 and 19X0, and for the year ended December 31, 19X1. We understand that your audits were made for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial status† and changes in financial status† of the Plan in conformity with generally accepted accounting principles, and whether the supplemental schedules are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Certain representations in this letter are described as being limited to matters that are material. Solely for purposes of preparing this letter individually or

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* In December 1999 the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which amends SAS No. 85 to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. This amendment adds the following item to the list of matters that should be addressed in a representation letter in connection with a financial statement audit:

> Management's belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Also, this amendment adds the following item to the illustrative management representation letter in paragraph 6 of appendix A of SAS No. 85:

> 5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [description of reasons]."

This amendment is effective for audits of financial statements for periods beginning on or after December 15, 1999 with early adoption permitted.

** For example, defined contribution pension and health and welfare plan audits would not need to include step 7 regarding actuarial assumptions.

*** For limited scope engagements, substitute the following for the first paragraph of this letter: We understand that, at our instruction, you did not perform any audit procedures with respect to information prepared and certified to by [*Name of Institution*], the trustee, in accordance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 (DOL Regulation 2520.103-5), other than comparing such information to the financial statements and supplemental schedules. Because of the significance of the information which we did not audit, we understand that you will not express an opinion on the financial statements and schedules taken as a whole.

† Defined contribution pension and health and welfare plans replace "financial status" with "net assets."

collectively in the aggregate, involving potential amounts of more than $______.[‡] These amounts are not intended to represent the materiality threshold for financial reporting and disclosure purposes. Notwithstanding this, items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [as of (*date of auditor's report*)] the following representations made to you during your audit.

1. We are responsible for the fair presentation in the Plan's financial statements of financial status[+] and changes in financial status[+] in conformity with generally accepted accounting principles [or other comprehensive basis of accounting] and for the fair presentation of the accompanying supplemental schedules in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The financial statements and related footnotes are fairly presented in conformity with generally accepted accounting principles [or other comprehensive basis of accounting] and the notes include all disclosures required by laws and regulations to which the plan is subject.
2. We have made available to you all—
   a. Financial records and related data.
   b. All minutes of the meetings [*name of plan administrative committee or trustee*], or summaries of actions of recent meetings for which minutes have not yet been prepared.
   c. Amendments made to the plan instrument, the trust agreement, or insurance contracts during the year, including amendments to comply with applicable laws.
3. There has been no—
   a. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices, that could have a material effect on the financial statements in the event of noncompliance.
   b. Fraud involving management or employees who have significant roles in the plan's internal control.
   c. Fraud involving other employees that could have a material effect on the financial statements.
4. We have no—
   a. Plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
   b. Intentions to terminate the plan.
5. The following have been properly recorded or disclosed in the financial statements:

[‡] The overall materiality level for the financial statement should not be used. The understanding reached on materiality limits with management, for purposes of their representation letter, should be sufficiently low to take into consideration known errors and undetected errors (allowance for detection risk).

[+] Defined contribution pension and health and welfare plans replace "financial status" with "net assets."

a. Related-party transactions, including transactions with parties-in-interest, as defined in ERISA section 3(14) and regulations thereunder, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.

b. Guarantees, whether written or oral, under which the plan is contingently liable to a bank or other lending institution.

c. All significant estimates and material concentrations known to management that are to be disclosed in accordance with AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* [We understand that the significant estimates covered by this disclosure are estimates at the balance sheet date that are reasonably possible of changing materially within the next year. Concentrations refer to the nature and type of investments held by the plan, or markets for which events could occur which would significantly disrupt normal finances within the next year.]

d. Amendments to the plan instrument, if any.

6. There are no—

a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.

c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

d. Transactions that have not been properly recorded in the accounting records underlying the financial statements.

e. Other matters (e.g., breach of fiduciary responsibilities, nonexempt transactions, loans or loans in default, events reportable to the PBGC, or events that may jeopardize the tax status) that legal counsel have advised us that must be disclosed.

[++]7. There were no omissions from the participants' data provided to the plan's actuary for the purpose of determining the actuarial present value of accumulated plan benefits and other actuarially determined amounts in the financial statements.[+++]

[++]8. The plan administrator agrees with the actuarial methods and assumptions used by the actuary for funding purposes and for determining accumulated plan benefits and has no knowledge or belief that such methods or assumptions are inappropriate in the circumstances. We did not give any, nor cause any, instructions to be given to the Plan's actuary with respect to values or amounts derived, and we are not aware of any matters that have impacted the independence or objectivity of the plan's actuary.

[++] These steps would not apply to defined contribution pension and health and welfare plans.

[+++] For health and welfare benefit plans that require the services of an actuary: There were no omissions from the participants' data provided to the plan's actuary for the purpose of determining the liability for claims incurred but not reported and other actuarially determined amounts in the financial statements.

#9. There have been no changes in [or the following have been properly recorded or disclosed in the financial statements:]—

a. The actuarial methods or assumptions used in calculating amounts recorded or disclosed in the financial statements.

b. Plan provisions between the actuarial valuation date and the date of this letter.

10. The plan has complied with all aspects of debt and other contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

11. The methods and significant assumptions used to estimate fair values of financial instruments are as follows: [*describe methods and significant assumptions used to estimate fair values of financial instruments*]. The methods and significant assumptions used result in a measure of fair value appropriate for financial measurement and disclosure purposes.

12. Financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk have been properly recorded or disclosed in the financial statements.

13. All required filings of plan [trust] documents with the appropriate agencies have been made.

14. The plan (and the trust established under the plan) is qualified under the appropriate section of the Internal Revenue Code and intends to continue as a qualified plan (and trust). The plan sponsor(s) has operated the Plan and trust or insurance contract in a manner that did not jeopardize this tax status.

15. The plan has complied with the Department of Labor's regulations concerning the timely remittance of participants contributions to trusts containing assets for the plan.

16. The plan has complied with the fidelity bonding requirements of ERISA.

17. The plan has satisfactory title to all owned assets, [state exceptions, if any] and all liens, encumbrances, or security interest requiring disclosure in the financial statements have been properly disclosed.

18. There are no—

a. Non-exempt party-in-interest transactions (as defined in ERISA section 3(l) and regulations under that section) that were not disclosed in the supplemental schedules or financial statements.

b. Investments in default or considered to be uncollectible that were not disclosed in the supplemental schedules.

c. Reportable transactions (as defined in ERISA section 103(b)(3)(H) and regulations under that section) that were not disclosed in the supplemental schedules.

19. We have apprised you of all communications, whether written or oral, with regulatory agencies concerning the operation of the plan.

For health and welfare benefit plans that require the services of an actuary: There were no omissions from the participants' data provided to the plan's actuary for the purpose of determining the liability for claims incurred but not reported and other actuarially determined amounts in the financial statements.

20. No events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____
[Name of Plan Administrator and Title]##

____
[Name of Plan Financial Officer and Title]

SEC Reporting Requirements

12.20 In certain circumstances, interests in plans and related entities are subject to the requirements of the Securities Exchange Act of 1933 (1933 Act). These requirements mandate registration, typically utilizing Form S-8 for plan securities, and subject the plan to the requirements of annual reporting on Form 11-K under the Securities Exchange Act of 1934 (1934 Act). Section 3(a)(2) of the 1933 Act provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the 1933 Act provided they are both voluntary and contributory.

12.21 Generally, a plan is both voluntary and contributory if the employees are given, at any point, the option to contribute their own funds to the plan knowing that such contributions may or will be used to acquire employer securities. This requirement is not limited to plans sponsored by employers with publicly traded securities. The advent of the 401(k) plan with multiple investment options, including an employer security option, has triggered SEC filings for many otherwise private companies. Plans that offer to sell employer securities generally are subject to the 1933 Act in the same manner as employers engaging in similar transactions, although there are specific exemptions. Advice of counsel should be obtained to determine if any of the exemptions may apply.

12.22 In lieu of the requirements of the 1934 Act, plans subject to ERISA may file plan financial statements and schedules prepared in accordance with the financial reporting requirements of ERISA. To the extent required by ERISA, the plan financial statements should be audited by an independent auditor. However, a limited-scope audit report under ERISA will not be accepted by the SEC. Reports on Form 11-K generally should be filed within 90 days after the end of the fiscal year of the Plan. Plans subject to ERISA that elect to file ERISA financial statements, may file the plan financial statements within 180 days after the plan's fiscal year-end. (See the Instructions to the Form 11-K, and Rule 15d-21 of the 1934 Act for filing alternatives.)

Form 5500

12.23 Information in the Form 5500 may be relevant to an independent audit or to the continuing propriety of the auditor's report. The auditor's responsibility for information in the Form 5500 does not extend beyond the

For multi-employer plans, consideration should be given to having the trustees (management/employer and labor/union) sign the management representation letter.

financial information identified in his or her report, and the auditor has no obligation to perform any procedures to corroborate other information contained in the Form 5500. However, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. If the auditor concludes that there is a material inconsistency, he or she should determine whether the financial statements, the auditor's report, or both require revision. If the auditor concludes that they do not require revision, he or she should ask the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, the auditor should consider other actions such as revising his or her report to include an explanatory paragraph describing the material inconsistency, withholding the use of the auditor's report in the document, and withdrawing from the engagement. The action he or she takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

12.24 If, while reading the other information contained in the Form 5500, the auditor becomes aware of information that he or she believes is a material misstatement of fact that is not a material inconsistency, the auditor should discuss the matter with the client. In connection with this discussion, the auditor should consider that he or she may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the auditor concludes that he or she has a valid basis for concern, the auditor should propose that the client consult with some other party whose advice might be useful, such as the client's legal counsel.

12.25 If, after discussing the matter, the auditor concludes that a material misstatement of fact remains, the action the auditor takes will depend on his or her judgment in the particular circumstances. The auditor should consider such steps as notifying the plan administrator in writing of his or her views concerning the information and consulting his or her legal counsel as to further appropriate action in the circumstances.

Reports Issued Prior to Form 5500 Filing

12.26 The auditor may encounter situations in which the financial statements and auditor's report are issued prior to the auditor's review of Form 5500. If such a situation occurs, the auditor should inform the plan administrator that the financial statements and auditor's report are not to be attached to the filing without the auditor's review of the filing on Form 5500. If an engagement letter is prepared, it should clearly state that if the financial statements and auditor's report are issued prior to the filing of Form 5500, those statements and report should not be attached to the filing without it being reviewed by the auditor. The auditor may also wish to consider including a statement in the transmittal letter to the client indicating that the financial statements and auditor's report, as presented, are not to be attached to the Form 5500 filing without the auditor's review of that filing.

12.27 ERISA requires a plan's financial statements to include a note explaining differences, if any, between amounts reported in the financial statements and the amounts reported in the Form 5500. If, upon review of the Form 5500 subsequent to the issuance of the plan's financial statements, the auditor identifies any such differences, he or she should reissue the auditor's report, dual-dated with respect to the note explaining the differences. If the differences represent a material inconsistency or misstatement of fact in the preparation of the Form 5500, guidance in paragraphs 12.23 through 12.25 should be followed.

Access to Auditors' Workpapers

12.28 The DOL believes that, under ERISA, it has a legal right to access auditor workpapers supporting the audited financial statements attached to the Form 5500. Consequently, the DOL may request an on-site review of auditor workpapers as part of its ongoing enforcement activities. (See AICPA, *Professional Standards*, vol. 1, AU section 9339.01–.15 for additional guidance on providing access to workpapers.)

Chapter 13

The Auditor's Report

13.01 This chapter provides guidance on the auditor's report on the financial statements of an employee benefit plan when—

a. The auditor expresses an unqualified opinion on financial statements presented in accordance with generally accepted accounting principles (paragraphs 13.03 through 13.08).

b. Supplemental schedules relating to ERISA and DOL regulations accompany the financial statements (paragraphs 13.09 through 13.19).

c. The financial statements have been prepared on a basis of accounting other than generally accepted accounting principles (paragraphs 13.20 through 13.23).

d. Information regarding accumulated plan benefits is omitted or is not measured in conformity with generally accepted accounting principles (paragraphs 13.24 and 13.25).

e. The scope of the audit was limited (paragraphs 13.26 through 13.30).

f. The auditor is reporting on the financial statements of a trust established under a plan (paragraph 13.31).

g. The plan's investments include nonreadily marketable securities, and either the valuation is appropriate but the range of possible values is significant or the investments are not valued in accordance with generally accepted accounting principles (paragraphs 13.32 through 13.36).

h. The plan auditor uses the work of other auditors regarding plan investments (paragraph 13.37).

i. A defined contribution plan provides investment options to participants, and the financial statements are presented in columnar format showing assets and changes in assets by the separate funds (paragraph 13.38).

j. The employee benefit plan is not expected to continue in existence (paragraphs 13.39 and 13.40).

The Auditor's Standard Report

13.02 The illustrative auditor's reports presented in this chapter have been prepared to present the standard auditor's reports on financial statements of employee benefit plans in accordance with SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79. These reports may be addressed to the plan or the trust whose financial statements are being audited, or to the plan administrator or board of trustees, or to participants and beneficiaries. Historically, the DOL has rejected Form 5500 filings that contain either qualified opinions, adverse opinions, or disclaimers of opinion other than those issued in connection with a limited scope audit pursuant to 29 CFR 2520.103-8 or 12.

Defined Benefit Plans

13.03 The following are illustrations of an auditor's report with an unqualified opinion on the financial statements of a defined benefit plan. In addition to the statement of net assets available for benefits and the statement of changes during the year in net assets available for benefits required by FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, the illustrations assume (unless otherwise noted) that information regarding the actuarial present value of accumulated plan benefits and changes therein is presented in separate financial statements.[66] Under an ERISA filing, as discussed in paragraph 13.09, an auditor's report should cover the required supplemental schedules. See paragraph 13.12 for guidance on the reporting on such supplemental schedules.

Illustration of Auditor's Report on Financial Statements of Defined Benefit Plan Assuming End-of-Year Benefit Information Date

13.04

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

[66] FASB Statement No. 35, as amended, permits variation in the presentation of information regarding the actuarial present value of accumulated plan benefits and changes therein. If such information is not presented in separate financial statements but is presented on the face of one or more financial statements or the notes thereto, the scope paragraph of the auditor's report should refer only to the financial statements that are presented. For example, if information regarding accumulated plan benefits and changes therein is presented in the notes to the financial statements regarding net assets available for benefits and changes therein, the first sentence of the auditor's report might read as follows: "We have audited the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and the related statement of changes in net assets available for benefits for the year then ended." The wording of the opinion paragraph would be the same as in the illustration and would refer to the financial status of the plan.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2 and 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with generally accepted accounting principles.[67]

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[*Signature of Firm*]

[*City and State*]

[*Date*]

Illustration of Auditor's Report on Financial Statements of Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

13.05

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 20X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the Plan's net assets available for benefits as of December 31, 20X2, and changes therein for the year then ended and its financial status as of December 31, 20X1, and changes therein for the year then ended in conformity with generally accepted accounting principles.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

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[67] APB Statement No. 4,* paragraph 133, states, "The financial position of an enterprise at a particular time comprises its assets, liabilities, and owners' equity and the relationship among them." FASB Statement No. 35, as amended, left unresolved the question of whether accumulated plan benefit information represents a liability of a defined benefit pension plan. Accordingly, since the financial statements of a defined benefit pension plan do not present information on accumulated plan benefits as a liability of the plan, and since they do not present an account comparable to the owners' equity of other types of entities, the auditor's opinion in the illustrative reports does not refer to the presentation of the financial position of the plan. The terms "financial status" and "changes in financial status," as used here, refer to the presentation of information regarding net assets available for plan benefits and changes therein and information regarding accumulated plan benefits and changes therein as specified in FASB Statement No. 35, as amended, (see FASB Statement No. 35, as amended, paragraph 235).

* Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*, rescinds APB Statement No. 4.

Defined Contribution Plans

13.06 The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of a profit-sharing plan.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 20X1 and 20X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X1 and 20X0, and the changes in net assets available for benefits for the year ended December 31, 20X1 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Health and Welfare Benefit Plans

[13.07] The illustrative auditor's report with an unqualified opinion on the financial statements of an employee benefit health and welfare benefit plan presented in previous editions of the guide has been deleted. Note that an unqualified opinion cannot be issued when SOP 92-6 has not been adopted.

13.08 The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of an employee health and welfare benefit plan, assuming that the provisions of SOP 92-6 have been adopted.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in benefits obligations for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2 and 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with generally accepted accounting principles.

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[Signature of Firm]

[City and State]

[Date]

Supplemental Schedules Relating to ERISA and DOL Regulations

13.09 Besides the financial statements and related disclosures, which may conform to the requirements of FASB Statement No. 35, ERISA and DOL regulations require additional information to be disclosed. Some of this information is required to be covered by the auditor's report (for example, supplemental schedules; see paragraph A.51(b)), but other required additional information need not be covered by the auditor's report. (The information required by ERISA and by the regulations is described in appendix A.)

13.10 SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, provides guidance on the form and content of reporting when the auditor submits to the client or others a document containing information accompanying the basic financial statements. Paragraph 6 of SAS No. 29 provides the following guidelines for the auditor's report in those circumstances:

a. The report should state that the audit has been performed for the purpose of forming an opinion on the basic financial statements taken as a whole.

b. The report should identify the accompanying information. (Identification may be by descriptive title or page number of the document.)

c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. The report may refer to regulatory agency requirements applicable to the information.

d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

e. The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or appear separately in the auditor-submitted document.

13.11 Although not required by SAS No. 29, when reporting on the supplemental schedules, auditor's may wish to include a statement that the supplemental schedules are the responsibility of the plan's management. Since the introductory paragraph of the standard audit report (paragraph 8 of SAS No. 58) identifies responsibilities between plan management and auditors as they relate to the financial statements only, this additional statement clarifies the responsibilities as they relate to the supplemental schedules. The example reports found throughout this chapter that report on the supplemental schedules include this additional statement.

13.12 An example of an auditor's report on supplemental schedules required by ERISA and DOL regulations, applicable to all types of employee benefit plans, follows.

<u>Independent Auditors' Report</u>

[*Addressee*]

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

13.13 When additional information is presented on which the auditor does not express an opinion, the information should be marked as unaudited or should refer to the auditor's disclaimer of opinion, and the last sentence of the preceding example paragraph should state the following: "The supplemental schedules have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on them."

13.14 In situations in which a disclaimer arises from the exemption permitted under 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA, see paragraph 13.26 in this guide for guidance on the reporting on the supplemental schedules.

13.15 In an audit in accordance with generally accepted auditing standards, the report need not state that the financial statements and schedules comply with the DOL filing requirements. During the audit, however, the auditor may become aware of a departure from such requirements that is not also a departure from generally accepted accounting principles.If the departure is not related to a prohibited transaction with a party in interest, the auditor should consider emphasizing the matter in an explanatory paragraph of the report. If the auditor becomes aware that the plan has entered into a prohibited transaction with a party in interest, and the transaction has not been properly disclosed in the required supplemental schedule, he or she should follow the guidance in paragraph 11.15.

13.16 When the auditor concludes that the supplemental schedules do not contain all required information or contain information that is inaccurate or is inconsistent with the financial statements, the auditor should consider, depending on the nature of the problem and the type of examination, either (*a*) modifying his or her report on the supplemental schedules by adding a paragraph to disclose the omission of the information or (*b*) expressing a qualified or an adverse opinion on the supplemental schedules, as appropriate. The following table illustrates the report modifications that an auditor might consider to be necessary when a required schedule, or information thereon, is omitted or is materially inconsistent with the financial statements.

	Report Modification		
		Limited-Scope Audit (defined in paragraph 7.53)	
Error, Omission, or Inconsistency	*Full Scope Audit*	*Exception in Information Certified by Trustee or Custodian*	*Exception in Information Not Certified by Trustee or Custodian But Tested by Auditor (see paragraph 7.53)*
Required information omitted from schedule, for example, historical cost information for nonparticipant directed transactions.	Explanatory paragraph	Explanatory paragraph	Qualified or adverse as to schedules
Required schedule omitted,* for example, schedule of reportable transactions	Explanatory paragraph	Explanatory paragraph	Qualified or adverse as to schedules
Required schedule materially inconsistent with financial statements	Qualified or adverse as to schedules	Explanatory paragraph	Qualified or adverse as to schedules

13.17

Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs that should be added to the auditor's report when the auditor should modify his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations.

Independent Auditors' Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.*]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied

* See paragraph 11.15 when Schedule of Prohibited Transactions is omitted.

in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose the historical cost of certain nonparticipant directed plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following paragraphs should be added to the auditor's report when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee's certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditors' Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.*]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan had loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

In the following illustration, the schedule of assets held for investment purposes which accompanies the Defined Contribution Plan's financial statements does not disclose that the Plan has loans to participants. Because the omitted participant loan information is information that is not certified by the trustee or custodian, an omission of participant loan information would require that a qualified or adverse opinion be issued on the applicable supplemental schedules (see table in paragraph 13.16).

Independent Auditors' Report

[*Addressee*]

[*Same first and second paragraphs as the limited-scope report.*]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan has loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

or

In the following illustration, the Plan has not presented the schedule of reportable transactions. Because the schedule of reportable transactions is information that is certified by the trustee or custodian, an omission of the schedule would require that an explanatory paragraph be added to the auditor's report (see table in paragraph 13.16).

Independent Auditors' Report

[*Addressee*]

[*Same first, second, and third paragraphs as the limited-scope report.*]

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

13.18 When the auditor concludes that the plan has entered into a prohibited transaction with a party in interest, and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (*a*) express a qualified opinion or an adverse opinion on the supplemental schedule[68] if the effect of the transaction is material to the financial statements or (*b*) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the effect of the transaction is not material to the financial statements. Illustrations of reports modified in those circumstances follow. All of the illustrations are presented assuming that the report on the supplemental schedules is added to the auditor's standard report on the basic financial statements (see paragraph 13.10*c*.)

Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditors' Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.*][69]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplemental information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[68] If a material party in interest transaction that is not disclosed in the supplemental schedule is also considered a related-party transaction and if that transaction is not properly disclosed in the notes to the financial statements, the auditor should express a qualified or adverse opinion on the financial statements as well as on the supplemental schedule. See paragraph 13.19.

[69] See footnote 68.

Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditors' Report

[Addressee]

[Same first, second, and third paragraphs as the standard report.][70]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan *[describe prohibited transaction]*. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____

[Signature of Firm]

[City and State]

[Date]

Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditors' Report

[Addressee]

[Same first, second, and third paragraphs as the standard report.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental

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[70] See footnote 68.

schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information, which is not considered material to the financial statements taken as a whole, is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]
[*Date*]

13.19 When the auditor concludes that the plan has entered into a prohibited transaction with a party in interest that is also considered a related-party transaction and is material to the financial statements, and the transaction has not been properly disclosed in the notes to the financial statements and the required supplemental schedule, the auditor should express a qualified or adverse opinion on the financial statements and the supplemental schedule. The following is an example of a qualified opinion issued on the financial statements of a profit-sharing plan, and the related supplemental schedules, under those circumstances.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statement of net assets available for benefits of XYZ Company Profit-Sharing Plan as of December 31, 20X1 and 20X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Plan's financial statements do not disclose that the Plan [*describe related-party transaction*]. Disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X1 and 20X0, and the changes in net assets available for benefits for the year ended December 31, 20X1 in conformity with generally accepted accounting principles.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the plan [*describe prohibited transaction*].

Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Non-GAAP-Basis Financial Statements

13.20 Present DOL regulations permit, but do not require, financial statements included in the annual report (Form 5500) to be prepared on a basis of accounting other than generally accepted accounting principles. Also, they do not prohibit variances from generally accepted accounting principles if the variances are described in a note to the financial statements.

13.21 A common example of the use of a basis other than generally accepted accounting principles is financial statements prepared on the modified cash basis of accounting for filing with the DOL. SAS No. 62, *Special Reports*, as amended by SAS No. 77, paragraphs 2 through 10, provides guidance on "Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles." SAS No. 62 is further clarified by an auditing interpretation, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.88). Included in the definition of a "comprehensive basis of accounting" are the cash basis and modifications thereof having substantial support. Cash basis financial statements that adjust securities investments to fair value are considered to be prepared on a modified cash basis of accounting.

13.22 The following is an illustration of an auditor's report on the financial statements of a defined benefit pension plan prepared on the modified cash basis. The illustration assumes that information on accumulated plan benefits is included in the notes to the financial statements.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits (modified cash basis) for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements and supplemental schedules were prepared on a modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits and the accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the changes in net assets available for benefits and changes in accumulated plan benefits for the year ended December 20X2, on the basis of accounting described in Note X.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

13.23 Paragraph 9 of SAS No. 62, as amended by SAS No. 77, states that when reporting on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditing interpretation of SAS No. 62, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.88), states that if cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. The interpretation states further that if GAAP sets forth requirements that apply to the preparation of financial statements, then cash, modified cash, and income tax basis statements should either comply with those requirements or provide information that communicates the substance of those requirements. The substance of

GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format. If the plan administrator prepares financial statements on a modified cash basis or other basis not in conformity with generally accepted accounting principles, he or she might consider not disclosing or qualitatively disclosing information regarding accumulated plan benefits (such as the amount of the plan's estimated accumulated plan benefits or accumulated benefit obligations, as applicable, and the amount of accumulated benefit obligations by type, for example, claims payable, IBNR, accumulated eligibility credits, and postretirement benefit obligations). Normally the plan would be unable to properly communicate the substance of these disclosures without providing the disclosures quantitatively. It may be acceptable to condense some of the quantitative disclosures (for example, to disclose the total amount currently payable to or for participants, beneficiaries, and dependents without breaking out how much relates to health claims payable versus death and disability benefits payable). If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or an adverse opinion on the financial statements.

Accumulated Plan Benefits—GAAP Departures and Changes in Accounting Estimates

13.24 As noted in paragraph 2.08, the financial statements of a defined benefit pension plan, prepared in conformity with generally accepted accounting principles, should include information regarding the actuarial present value of accumulated plan benefits and the effects, if significant, of certain factors affecting the year-to-year change in accumulated plan benefits. If the benefit information either is omitted or is not appropriately measured in conformity with FASB Statement No. 35, the auditor should express a qualified or adverse opinion (see paragraph 13.23 regarding omitted disclosures in non-GAAP-basis financial statements).

13.25 The auditor's report need not be modified as to consistency for changes in actuarial assumptions, changes that merely result in presenting new or additional accumulated plan benefits information, a change in the format of presentation of accumulated plan benefit information (for example, from a separate statement to disclosure in the notes to the financial statements) or a change from presenting the accumulated plan benefit information (of a defined benefit pension plan) as of the beginning of the year to presenting it as of the end of the year (see AICPA, *Professional Standards*, vol. 1, AU section 9420.64 and .65).

Limited-Scope Audits Under DOL Regulations

13.26 As discussed in paragraph 7.52, under DOL regulations the plan auditor need not examine and report on certain information prepared by banks, similar institutions, or insurance carriers that are regulated, supervised, and subject to periodic examination by a state or federal agency if that information is certified as complete and accurate by the bank or similar institution, or an insurance carrier (see paragraphs A.57 and A.58). Thus the plan administrator may restrict the auditor's examination of the assets held and transactions executed by such institutions. The following is an example of the auditor's report for a defined benefit pension plan, in these circumstances when he or she believes this to be a significant limitation on the scope of the audit.[71]

Independent Auditors' Report

[*Addressee*]

We were engaged to audit the financial statements and supplemental schedules of XYZ Pension Plan as of December 31, 20X1 and 20X0, and for the year ended December 31, 20X1, as listed in the accompanying index. These financial statements and supplemental schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the years ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee or custodian, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

13.27 As discussed in paragraph 7.48, plan investments not held by a qualified trustee/custodian that meet the limited-scope exemption criteria set forth in the DOL regulations (see paragraphs A.57 and A.58 for a discussion of such criteria) should be subjected to appropriate audit procedures. Plans may hold investment assets only a portion of which are covered by a certification by a qualified trustee/custodian. In that case, the balance of the investments are not eligible for the limited-scope exemption and should be subjected to auditing procedures by the plan auditor. In these circumstances, the limited-scope audit report would be required if the plan's assets that are not audited (i.e., those assets covered by the trustee/custodian's certification) are material to the plan's financial statements taken as a whole.

[71] If the plan's financial statements are prepared on the cash basis or a modified cash basis of accounting, the auditor's report should also include a paragraph stating the basis of presentation and that cash basis is a comprehensive basis of accounting other than GAAP. Paragraph 13.22 provides an illustration of the wording of such paragraph.

Limited-Scope Audit in Prior Year

13.28 An employee benefit plan administrator may elect not to limit the scope of the audit in the current year even though the scope of the audit in the prior year was limited in accordance with DOL regulations.[72] The following illustrates a report on comparative financial statements of a defined benefit pension plan under those circumstances.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the statements of accumulated plan benefits as of December 31, 20X2 and 20X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 20X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 20X1. The form and content of the information included in the 20X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 20X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2, and changes in its financial status for the year then ended in conformity with generally accepted accounting principles.

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[72] Present DOL regulations prescribe that the annual report include a statement of net assets available for benefits on a comparative basis; the statement of changes in net assets available for benefits is required for the current year only.

Our audit of the Plan's financial statements as of and for the year ended December 31, 20X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 20X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Limited-Scope Audit in Current Year

13.29 A plan may exclude from the auditor's examination its assets held by banks or insurance companies in the current year, whereas the scope of the audit in the prior year was unrestricted. When comparative financial statements will be issued in those circumstances, the auditor should report on the prior year's financial statements of the plan. Although the auditor's report should ordinarily be dated as of the completion of the most recent audit, the procedures performed in an audit that has been restricted, as permitted by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure, generally are not sufficient to enable the auditor to update the report on the prior year's financial statements. Accordingly, the auditor should consider referring to the date of the previously issued report on the prior year's financial statements in expressing an opinion on that information. The following illustrates a report on comparative financial statements of a defined benefit pension plan in those circumstances.[73]

Independent Auditors' Report

[*Addressee*]

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2 and the supplemental schedules of (1) assets held for investment purposes, (2) transactions in excess of 5 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the

[73] This illustration assumes that information regarding accumulated plan benefits and changes therein is included in the notes to the financial statements.

related information included in the 20X2 financial statements and the supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan's 20X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 20X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X1, and in our report dated May 20, 20X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X1, in conformity with generally accepted accounting principles.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

Limited-Scope Audit for Multiemployer Pension Plan

13.30 The following is an example of the auditor's report disclaiming an opinion on the financial statements of a multiemployer defined benefit pension plan when the auditor has been unable to apply all the procedures he or she considers necessary with regard to participants' data maintained by, and contributions from, the sponsor companies.*

Independent Auditors' Report

[*Addressee*]

We were engaged to audit the statements of [identify] of XYZ Multiemployer Pension Plan as of December 31, 20X2 and 20X1, and for the years then ended. These financial statements are the responsibility of the Plan's management.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

* Historically, the DOL has rejected Form 5500 filings that contain either qualified opinions, adverse opinions, or disclaimers of opinion other than those issued in connection with a limited scope audit pursuant to 29 CFR 2520.103-8 or 12.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

Reporting on the Financial Statements of a Trust Established Under a Plan

13.31 Under both FASB Statement No. 35 and ERISA, the reporting entity is the employee benefit plan. However, the plan administrator may engage an independent auditor to report on the financial statements of a trust established under the plan. In such audits, the auditor should observe the applicable provisions of this guide. Users of the financial statements of the trust may not be aware of the distinction between the trust and the plan. Therefore, when reporting on such a trust, the auditor's report should explain that the financial statements of the trust do not purport to present the financial status or changes in financial status of the plan in accordance with generally accepted accounting principles and that the financial statements do not purport to satisfy the DOL reporting and disclosure requirements. The following is an example of the auditor's report on the financial statements of a trust established under an employee benefit plan.

<u>Independent Auditors' Report</u>

[*Addressee*]

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 20X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of ABC Pension Trust as of December 31, 20X2, and the changes in its net assets and trust balance for the year then ended in conformity with generally accepted accounting principles.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for a fair presentation of the financial status of XYZ Pension Plan in conformity with generally accepted accounting principles. Furthermore, these statements do not purport to satisfy the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 relating to the financial statements of employee benefit plans.

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[Signature of Firm]

[City and State]
[Date]

Nonreadily Marketable Investments

13.32 ERISA defines current value as "fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary." Investments for which fair market value may not be readily determinable include such items as securities that are not readily marketable, private debt placements, and real estate investments (see paragraphs 2.11 through 2.13).

13.33 A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive evidential matter concerning its outcome would be expected to become available. Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available.

13.34 When the financial statements include securities whose values were estimated by the plan (for example, board of trustees, plan administrator, investment committee, or other named fiduciary) in the absence of readily ascertainable market values, an assessment of whether the evidential matter is sufficient to support management's analysis should be made. The guidance in SAS No. 81, *Auditing Investments*,* may be helpful in making that assessment. If, after considering the existing conditions and available evidence supporting the plan's good-faith estimate of value the valuation principles are acceptable, are being consistently applied, and are reasonably supported by the documentation, an unqualified opinion ordinarily is appropriate.

13.35 If the auditor's review discloses that the valuation procedures followed by the plan are inadequate or unreasonable, or if the underlying documentation does not appear to support the valuation, the auditor should consider the need to express a qualified opinion or disclaim an opinion because of a scope limitation. Such an opinion would be appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or restrictions imposed by management.

* The AICPA Auditing Standards Board plans to release a new SAS that would supersede SAS No. 81. Readers should be alert for the issuance of this SAS.

13.36 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to a departure from generally accepted accounting principles due to an uncertainty. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. The auditor should issue a qualified or an adverse opinion because of a departure from generally accepted accounting principles. The following illustration provides an example of an auditor's report on a defined benefit pension plan qualified for a departure from generally accepted accounting principles because of inadequate procedures to value investments. The illustration assumes that the auditor cannot reasonably determine the effects of the departure.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1 and of accumulated Plan benefits as of December 31, 20X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X, investments amounting to $_____ (__ percent of net assets available for benefits) as of December 31, 20X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with generally accepted accounting principles. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2 and information regarding the Plan's net assets available for benefits as of December 31, 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 20X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Reference to the Work of Other Auditors

13.37 Throughout this guide, circumstances are discussed in which the plan auditor may use the work of another auditor regarding plan investments. For example, the plan auditor may use the report of the independent auditor of the financial statements of a common or commingled trust fund or a separate account to obtain assurance regarding significant amounts of the plan's assets, and the auditor may use a service auditor's report on the processing of transactions by a service organization (see SAS No. 70) in considering the plan's internal control. Although the amount of the plan's assets covered by the other auditor's report or relating to internal control covered by the service auditor's report may be material in relation to the net assets of the plan, the plan auditor ordinarily would be the principal auditor. The work of the other auditor is used by the plan auditor in obtaining an understanding of internal control relating to plan investments. Because the plan auditor performs procedures with respect to investments, contributions, benefit payments, plan obligations, participants' data, and other elements of the financial statements, the plan auditor is ordinarily the only auditor in a position to express an opinion on the plan's financial statements taken as a whole. The plan auditor may use reports by other auditors in the audit of the plan's financial statements, but the other auditors are not responsible for examining a portion of the plan's financial statements as of any specific date or for any specific period. Thus, there cannot be a meaningful indication of a division of responsibility for the plan's financial statements. Therefore, the plan auditor should not refer to the other auditors in his or her report in such circumstances.

Reporting Separate Investment Fund Information

13.38 Requirements for presenting information related to separate investment fund options of defined contribution plans are described in paragraph 3.28(*k*). Article 6A of Regulation S-X addresses reporting requirements for profit sharing, stock bonus, thrift or savings, and similar plans, that are required to file reports with the SEC. Those rules, which are similar to those in paragraph 3.28(*k*), allow a plan providing for investment programs with separate funds to present the required information either in columnar form in the financial statements, or by separate financial statements for each fund, or in schedules. The SEC amended its rules for Form 11K to permit plans subject to ERISA to file financial statements in accordance with ERISA rather than in accordance with Regulation S-X. Accordingly, adherence to the requirements of paragraph 3.28(*k*) and other pertinent GAAP and ERISA requirements described in this guide should satisfy the SEC rules.

Terminating Plans

13.39 The accounting and reporting by a defined benefit pension plan for which a decision to terminate has been made are described in paragraphs 2.48 through 2.52. The auditor may express an unqualified opinion on financial statements prepared on the liquidation basis of accounting, provided the basis has been properly applied and that adequate disclosures are made in the financial statements. The auditor's report normally should be modified by the addition of an explanatory paragraph that states that the plan is being terminated and that the financial statements (including the benefit information disclosures presented) have been prepared on a liquidation basis. If the financial statements are presented along with financial statements of a period prior to adoption of a liquidation basis that were prepared on the basis of generally accepted accounting principles for ongoing plans, the explanatory paragraph should state that the plan has changed the basis of accounting used to determine the amounts at which assets, liabilities, and benefit information are presented from the ongoing plan basis to a liquidation basis. The following is an illustration of the explanatory paragraph when the auditor wishes to emphasize that a defined benefit pension plan is being terminated:

> As further discussed in Notes A and B to the financial statements, the Board of Directors of the XYZ Company, the Plan's sponsor, voted on November 9, 20X2 to terminate the Plan. In accordance with generally accepted accounting principles, the Plan has changed its basis of accounting used to determine the amounts at which investments in insurance contracts and the accumulated benefit information are stated, from the ongoing plan basis used in presenting the 20X1 financial statements to the liquidation basis used in presenting the 20X2 financial statements.

13.40 During the audit of a nonterminated employee benefit plan, the auditor may become aware that the plan sponsor may not be able to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminently potential impact on the plan entity. The auditor should consider the sponsor's plans for dealing with its conditions, and in that regard the auditor should refer to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended by SAS No. 77. SAS No. 77 amends SAS No. 59 to preclude the auditor from using conditional language in expressing a conclusion concerning the existence of substantial doubt about the plan's ability to continue as a going-concern in a going-concern explanatory paragraph.

Initial Audits of Plans

13.41 For initial audits of plans where the plan had assets in the prior year, ERISA requires presenting a comparative statement of net assets available for plan benefits. Comparative statements are not required under generally accepted accounting principles. Generally sufficient auditing procedures can be performed on the prior year's balances if the records are complete (paragraph 5.13) so that the auditor can express an unqualified opinion or a limited-scope opinion on the prior year's statement of net assets available for plan benefits. If the prior-year's financial statements have not been audited, the prior year statement(s) should be marked to indicate their status (either reviewed or compiled). Additional guidance on the reporting on audited and unaudited financial statements in comparative form is contained in SAS No. 26, *Association With Financial Statements*, and Statement on Standards for Accounting and Review Services (SSARS) 2, *Reporting on Comparative Financial Statements*.

13.42 When the financial statements of the prior period have not been audited (but a statement of net assets is included for comparative purposes in compliance with the regulations), the report on the current period should contain an additional paragraph. This paragraph should include (*a*) a statement of the level of service performed in the prior period, (*b*) the date of the report on that service, (*c*) a description of any material modifications noted in that report, and (*d*) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole (SAS No. 26, paragraph 17). However, when the accountant performs more than one service for a prior period (for example, a compilation and an audit), he or she should issue the report that is appropriate for the highest level of service rendered (SSARS 1, *Compilation and Review of Financial Statements*, paragraph 5).

Appendix A

ERISA and Related Regulations

Introduction

A.01 The following description, prepared with the assistance of the Pension and Welfare Benefits Administration, U.S. Department of Labor, is intended to enable the auditor to familiarize himself or herself with the important provisions of the Employee Retirement Income Security Act of 1974 (ERISA). This is a summary and is not intended to serve as a substitute for the entire Act, the related regulations, or for the advice of legal counsel. Changes in the statute and related regulations subsequent to publication of this guide also should be considered.

A.02 The primary purpose of ERISA is to protect the interests of workers who participate in employee benefit plans and their beneficiaries. ERISA seeks to attain that objective by requiring financial reporting to government agencies and disclosure to participants and beneficiaries, by establishing standards of conduct for plan fiduciaries, and by providing appropriate remedies, sanctions, and access to the federal courts. Another objective of ERISA is to improve the soundness of employee pension benefit plans[74] by requiring plans (*a*) to vest the accrued benefits of employees with significant periods of service, (*b*) to meet minimum standards of funding, and (*c*) with respect to defined benefit pension plans, to subscribe to plan termination insurance through the Pension Benefit Guaranty Corporation (PBGC).

A.03 ERISA replaced the Welfare and Pension Plans Disclosure Act of 1958, amended certain sections of the Internal Revenue Code (IRC), and generally preempted state laws that related to employee benefit plans.

Coverage Under Title I

A.04 Title I of ERISA generally applies to employee benefit plans established or maintained by employers engaged in interstate commerce or in any industry or activity affecting interstate commerce or by employee organizations representing employees engaged in such activities, or by both employer and employee organizations.[75] Most aspects of ERISA do not apply to—

a. Governmental plans, including those of state and local governments.

b. Church plans unless the plan has made a voluntary election under IRC section 410(d).

c. Plans established and maintained solely for the purpose of complying with applicable workers' compensation, unemployment compensation, or disability insurance laws.

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[74] Pension plans are broadly defined in ERISA to include all defined benefit and defined contribution plans, including profit-sharing, stock bonus, and employee stock ownership plans.

[75] There is no correlation between coverage under Title I of ERISA and qualification under the IRC.

d. Plans maintained outside the United States primarily for nonresident aliens.[76]

e. Unfunded excess benefit plans (ERISA section 3(36)).[77]

Participant Standards for Pension Plans (ERISA Section 202)[78]

A.05 ERISA generally provides that a pension plan cannot exclude an employee from participation because of age or service if he or she has completed one year of service and is at least twenty-one years old. However, a pension plan may defer participation until attainment of age twenty-one and two years of service, provided that benefits vest 100 percent thereafter. In addition, ERISA provides that an individual may not be denied the right to participate in a plan on the basis of having attained a specific age.

Vesting Standards for Pension Plans (ERISA Section 203)

A.06 Pension plan participants' rights to accrued benefits from their own contributions are nonforfeitable. In addition, generally, plans must provide that the employees' rights to accrued benefits from employer contributions vest in a manner that equals or exceeds either of two alternative schedules: (*a*) graded vesting of accrued benefits, with at least 20 percent vesting after three years of service, at least 20 percent each year thereafter for four years, so that the employee's accrued benefit would be 100 percent vested after seven years; and (*b*) 100 percent vesting of accrued benefits after five years of service, with no vesting required before the end of the five-year period.

A.07 Tax-qualified plans require more stringent vesting if there is a termination, partial termination, or discontinuance of contribution to the plan, or the plan is top-heavy (IRC sections 411(d) and 416).

A.08 For computation of years of service as they relate to an employee's vesting rights, a year of service is defined in ERISA as a twelve-month period during which the participant has completed at least 1,000 hours of service (ERISA section 203(b)(2)). Regulations that refine that definition are complex. In addition, complex rules apply that define breaks in service.

A.09 Sufficient records must be maintained to determine an employee's benefits. ERISA section 105 generally requires that the plan administrator, on request, furnish to participants and beneficiaries under the plan the latest information available about their total benefits accrued and the nonforfeitable benefits, if any, that have accrued or the earliest date on which benefits will become nonforfeitable. ERISA section 209 requires a similar statement to be furnished upon request, as well as upon a termination or break in service. ERISA section 209 also requires the maintenance of records relating to individual benefit reporting. ERISA section 107 provides general record retention requirements for employee benefit plans.

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[76] The phrase "Plans maintained outside the United States" does not include a plan that covers residents of Puerto Rico, the U.S Virgin Islands, Guam, Wake Island, or America Samoa.

[77] Certain plans excluded from Title I and "fringe benefit plans," as defined in Exhibit A-4, are nonetheless required under the IRC to file annual reports with the IRS (see A.18 through A.28).

[78] Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) generally transferred from the Secretary of Labor to the Secretary of the Treasury regulatory and interpretative authority for Parts 2 and 3 of Title I of ERISA.

Minimum Funding Standards for Pension Plans (ERISA Sections 301 Through 306)

A.10 ERISA requires that pension plans subject to the minimum funding standards maintain an account called the *funding standard account* (FSA). This account is a memorandum account, and it is not included in the plan's financial statements. Defined benefit pension plans are required to maintain an FSA. Certain defined contribution plans (that is, money-purchase and target-benefit plans) must maintain FSAs, but on a more limited basis. The FSA is used to determine compliance with minimum funding standards set forth in ERISA.

A.11 For most defined benefit pension plans, the sponsor's annual contribution to the plan must be sufficient to cover the normal cost for the period, and the amount to amortize initial unfunded past service liability, and increases or decreases in unfunded past service liability resulting from plan amendments, experience gains or losses, and actuarial gains or losses from changes in actuarial assumptions.

A.12 An accumulated funding deficiency is the excess of total charges (required contributions) to the FSA for all plan years (beginning with the first plan year when the funding standards are applicable) over total credits (actual contributions) to the account for those years. Accumulated funding deficiencies, in the absence of a funding waiver issued by the IRS, may result in an excise tax payable by the plan sponsor for failure to meet the minimum funding standards and in possible action by the IRS to enforce the standards. If there is a deficiency in the FSA at the end of the plan year, the auditor should consider whether a receivable from the employer company (and, possibly, a related reserve for uncollectible amounts) should be reflected in the plan's financial statements (see chapter 8 for a discussion of contributions receivable).

A.13 The IRS may waive all or part of the minimum funding requirements for a plan year in which the minimum funding standard cannot be met without imposing substantial business hardship on the employer. That waiver is issued, however, only if failure to do so would be adverse to the participants' interests. The IRS determines whether a substantial hardship would occur on the basis of various factors, certain of which are stated in ERISA section 303. This does not change the plan's possible need to record a contribution receivable.

Trust Requirements

A.14 Tax laws require that qualified pension, profit-sharing, and stock bonus plans be funded through a trust. The Internal Revenue Code (IRC) does not contain any such requirement for welfare benefit plans or fringe benefit plans. ERISA generally requires, however, that the assets of all employee benefit plans, including welfare plans, be held in trust. Participant contributions, including salary reduction amounts, are considered to be employee contributions under ERISA and generally do constitute "plan assets." An employer is required to segregate employee contributions from its general assets as soon as practicable, but in no event more than (*a*) ninety days after the contributions are paid by employees or withheld from their wages for a welfare benefit plan or (*b*) the 15th business day following the end of the month in which amounts are contributed by employees or withheld from their wages for a pension benefit plan [ref. DOL Reg. 2510.3-102]. The DOL has announced that it will not presently enforce the trust requirement for cafeteria plans under IRC section 125 to which employees make contributions. This policy also temporarily relieves contributory welfare plans from compliance with the trust requirements of ERISA with respect to participant contributions used to pay insurance premiums in accordance with the Department's reporting regulations.*

Voluntary Employee Benefit Associations (VEBAs)

A.15 A VEBA is a welfare trust under IRC section 501(c)(9). Generally, plans funded by a section 501(c)(9) trust must be audited unless it is exempt under the fewer-than-100-participants rule.

Reporting and Disclosure for Pension and Welfare Plans (ERISA Sections 101 Through 111 and 1031 Through 1034)

A.16 ERISA generally requires that the administrator of an employee benefit plan prepare and file various documents with the DOL, the IRS, and the PBGC. Under Title I of ERISA, the plan administrator is required to furnish to the DOL, upon request, any documents relating to the employee benefit plan, including but not limited to, the latest summary plan description (including any summaries of plan changes not contained in the summary plan description), and the bargaining agreement, trust agreement, contract, or other instrument under which the plan is established or operated (ERISA section 104(a)(6)). In addition, most plans are required to file an annual report that also satisfies the annual reporting requirements of Titles I and IV of ERISA (sections 104(a)(1)(A), 1031 and 4065) and the Internal Revenue Code. Title I of ERISA also requires that the plan administrator furnish certain information relative to the employee benefit plan to each participant and beneficiary receiving benefits under the plan. These disclosures include summary plan descriptions, including summaries of changes and updates to the summary plan description (section 104(b)(1)), summary annual reports (section 104(b)(3)), and, in the case of most pension plans, individual benefit reports describing the participant's accrued and vested benefits under the plan (sections 105 and 209).

Annual Report

A.17 The report of most significance to the auditor is the annual report. The annual report required to be filed for employee benefit plans generally is the Form 5500. The Form 5500 is a joint-Agency Form developed by the IRS, DOL, and PBGC, that may be used to satisfy the annual reporting requirements of the IRC and Titles I and IV of ERISA. For purposes of Title I of ERISA only, a plan administrator may, in lieu of filing the Form 5500, elect to file the information required by ERISA section 103. However, almost all plan administrators use the Form 5500. Use of the Form 5500 is required for filings under the IRC and Title IV of ERISA.

Who Must File

A.18 An administrator of an employee benefit plan subject to ERISA, and not otherwise exempt, must file an annual report for each such plan every year (see ERISA sections 104, 1031, and 4065).[79] The IRS, DOL, and PBGC have

* See 29 CFR 2520.104-20(b)(2)(ii) or (iii) and 29 CFR 2520.104-44(b)(1)(ii) or (iii), as applicable.

[79] IRC section 6039D also requires certain other entities to file with the IRS. When these entities are required to file Form 5500 or 5500-C/R, the instructions to the forms refer to these entities as "fringe benefit plans."

consolidated their requirements into the Form 5500 to minimize the filing burden for plan administrators and employers. Furthermore, beginning with the 1999 filing year, the agencies have replaced the Form 5500 Series with one form, the Form 5500, intended to streamline the report and the methods by which it is filed and processed. Likewise, direct filing entities (DFE), described below, are also now required to use the new Form 5500 when reporting to the DOL. In general, the Form 5500 reporting requirements vary depending on whether the Form 5500 is being filed for a "large plan," a "small plan," or a DFE, and on the particular type of plan or DFE involved. Plans with 100 participants as of the beginning of the plan year must complete the Form 5500 following the requirements for a "large plan." Plans with fewer than 100 participants should follow the requirements for a "small plan." In addition, DOL regulations permit plans that have between 80 and 120 participants (inclusive) at the beginning of the plan year to complete the Form 5500 in the same category ("large plan" or "small plan") as was filed for the previous year. For 1999, this means that plans with between 80 and 120 participants at the beginning of the plan year that filed a Form 5500-C/R in 1998 could elect to complete the 1999 Form 5500 following the requirements for a "small plan." The Form 5500 is filed with the PWBA in Lawrence Kansas, in accordance with the instructions to the form.

Participants

A.19 ERISA section 3(7) defines a participant as any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan that covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.

A.20 For Code section 401(k) qualified cash or deferred arrangement, "participants" mean any individual who is eligible to participate in the plan whether or not the individual elects to contribute or has an account under the plan [ref: DOL Reg. 29 CFR 2510.3-3(d) and the Form 5500 Instructions]. However, a "participant" in a fringe benefit plan means any individual who has had at least one dollar excluded from income by reason of Code section 120, 125, or 127.* It also should be noted, however, that the determination of the number of participants in a welfare benefit plan, whether or not implemented in conjunction with a cafeteria plan, is determined by reference to 29 CFR 2510.3-3(d).

Stop-Loss Coverage

A.21 Many self-funded plans carry stop-loss coverage to limit either the plan's or employer's loss exposure. Stop-loss coverage is a contract with an insurer that provides that the insurer will pay claims in excess of a specified amount. The coverage may be aggregate (that is, the insurer will pay if total claims exceed the specified amount) or specific (that is, the insurer will pay if an individual claim exceeds the specified amount). Plans that have stop-loss insurance may qualify for an exception from either the annual return/report or the audit requirement depending on the number of participants covered under the plan and the category of return/report filed (for example, "large plan" or "small plan").

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* See line 5 of Schedule F (1992 Form 5500).

Plans Required to File the Annual Report and Audited Financial Statements

A.22 Generally, plans subject to Part 1 of Title I of ERISA require an audit. Certain plans are not covered by ERISA and accordingly are not subject to the federal audit requirement (for example, governmental plans, church plans, unfunded excess benefit plans, plans maintained solely for the purpose of complying with applicable workmen's compensation, unemployment, or disability insurance laws, and plans maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens). In addition, it should be noted that the plan administrator's obligation to retain an accountant to audit the plan continues to remain in effect even when the plan loses its tax-qualified status.

Who Must Engage an Independent Qualified Public Accountant

A.23 Employee benefit plans filing the Form 5500 as a "large plan," (i.e., plans with 100 or more participants) are generally required to engage an IQPA pursuant to ERISA section 103(a)(3)(A). In counting participants for these purposes, an individual usually becomes a participant under a welfare plan when he or she becomes eligible for a benefit, and under a pension plan when he or she has satisfied the plan's age and service requirements for participation (see paragraph 5.09 and instructions to the Form 5500 Annual Return/Report). An IQPA's opinion must also be attached to Form 5500 unless (*a*) the plan is an employee welfare benefit plan that is unfunded, fully insured, or a combination of unfunded and insured as described in 29 CFR 2520.104-44(b)(1);[80] (*b*) the plan is an employee pension benefit plan whose sole asset(s) consist of insurance contracts that provide that, upon receipt of the premium payment, the insurance carrier fully guarantees the amount of benefit payments as specified in 29 CFR 2520.104-44(b)(2) and the Form 5500 instructions;[81] or (*c*) the plan has elected to defer attaching the accountant's opinion for the first of two plan years, one of which is a short plan year of seven months or less as allowed by 29 CFR 2520.104-50[82] (see paragraphs A.60 and A.67, 29 CFR 2520.104-50, and the instructions to the Form 5500).

Pension Benefit Plans

A.24 An annual report is generally required to be filed even if (*a*) the plan is not qualified, (*b*) participants no longer accrue benefits, and (*c*) contributions were not made for the plan year. The following are among the pension benefit plans for which a Form 5500 Annual Return/Report must be filed:

- Annuity arrangements under IRC section 403(b)(1)
- Custodial account established under IRC section 403(b)(7) for regulated investment company stock

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[80] Single employer welfare plans using an IRC section 501(c)(9) trust are generally not exempt from the requirement of engaging an independent qualified public accountant. See paragraph A.35 for an explanation of the welfare plans considered to be unfunded, fully insured, or a combination of unfunded and insured.

[81] See paragraph A.68*n*.

[82] 29 CFR 2520.104-50 permits the administrator of an employee benefit plan to defer the audit requirement for the first of two consecutive plan years, one of which is a short plan year of seven or fewer months' duration, and to file an audited statement for that plan year when the annual report is filed for the immediately following plan year, subject to certain conditions.

- Individual retirement account established by an employer under IRC section 408(c)
- Pension benefit plan maintained outside the United States primarily for nonresident aliens if the employer who maintains the plan is a domestic employer, or a foreign employer with income derived from sources within the United States (including foreign subsidiaries of domestic employers) and deducts contributions to the plan on its U.S. income tax return
- Church plans electing coverage under IRC section 410(d)

Pension benefit plans generally provide retirement income and include—

- Defined benefit plans; and
- Defined contribution plans, including profit-sharing plans, money-purchase pension plans, stock-bonus and employee stock-ownership plans (ESOPs), and 401(k) and other thrift or savings plans.

General Filing Requirements:

- Plans with 100 or more participants at the beginning of the plan year must file the Form 5500 following the requirements for "large plans."
- Plans with fewer than 100 participants at the beginning of the plan year must file the Form 5500 following the requirements for "small plans."

Exception:

Pursuant to DOL Regulation 29 CFR 2520.103-1(d), plans that have between 80 and 120 participants (inclusive) at the beginning of the plan year may complete the Form 5500 in the same category ("large plan" or "small plan") as was filed for the previous year. For 1999, this means that plans with between 80 and 120 participants at the beginning of the plan year that filed a Form 5500-C/R in 1998 could elect to complete the 1999 Form 5500 following the requirements for a "small plan." Plans that file the Form 5500 as a "small plan" pursuant to the 80/120 rule are not required to have an audit of their financial statements [ref: DOL Reg. 29 CFR 2520.104.46].

General Audit Requirements:

- Plans with 100 or more participants at the beginning of the plan year that file the Form 5500 as a "large plan" are required to have an annual audit of their financial statements.
- Plans with fewer than 100 participants at the beginning of the plan year that file the Form 5500 as a "small plan" are exempt from the audit requirement.

General Exemptions From Filing and Audit Requirements:

- Plans that are unfunded or fully insured and provide benefits only to a select group of management or highly compensated employees. *Note:* There is a one-time DOL notification requirement for "top hat" plans [ref: DOL Reg. 29 CFR 2520.104-23].

General Exemptions From Audit Requirement Only:

Plans, irrespective of the number of participants at the beginning of the plan year, that—

- Provide benefits exclusively through allocated insurance contracts. A contract is considered to be allocated only if the insurance company or organization that issued the contract unconditionally guarantees, upon receipt of the required premium or consideration, to provide a retirement benefit of a specified amount, without adjustment for fluctuations in the market value of the underlying assets of the company or organization, to each participant, and each participant has a legal right to such benefits that is legally enforceable directly against the insurance company or organization;

- Are funded solely by premiums paid directly from the general assets of the employer or the employee organization maintaining the plan, or partly from such general assets and partly from contributions from employees;
- Forward any participant contributions within three months of receipt; and
- Provide for the return of refunds to contributing participants within three months of receipt by the employer or employee organization [ref: DOL Reg. 29 CFR 2520.104-44(b)(2)].

Welfare Benefit Plans

A.25 These plans are described in section 3(1) of Title I of ERISA. An employee welfare benefit plan includes any plan, fund, or program that provides, through the purchase of insurance or otherwise, medical, surgical, hospital, sickness, accident, disability, severance, vacation, prepaid legal services, apprenticeship, and training benefits for employees.*

General Filing Requirements:

- Plans with 100 or more participants at the beginning of the plan year must file the Form 5500 as a "large plan."
- Plans with fewer than 100 participants at the beginning of the plan year must file the Form 5500 as a "small plan."

Exception:

Pursuant to DOL Reg. 29 CFR 2520.103-1(d), a plan that covers between 80 and 120 participants at the beginning of the plan year may elect to complete the Form 5500 in the same category ("large plan" or "small plan") as was filed for the previous year. For 1999, this means that plans with between 80 and 120 participants at the beginning of the plan year that filed a Form 5500-C/R in 1998 could elect to complete the 1999 Form 5500 following the requirements for a "small plan." Plans that file the Form 5500 as a "small plan" pursuant to the 80/120 rule are not required to have an audit of their financial statements [ref: DOL Reg. 29 CFR 2520.104-46].

General Audit Requirements:

- Plans with 100 or more participants at the beginning of the plan year that file the Form 5500 as a large plan are required to have an annual audit of their financial statements.
- Plans with fewer than 100 participants at the beginning of the plan year that file the Form as a "small plan" are exempt from the audit requirement.

General Exemptions From Filing and Audit Requirements:

- Plans that are unfunded or fully insured and provide benefits only to a select group of management or highly compensated employees. Note: The Department of Labor can require that certain information be provided upon request [ref: DOL Reg. 29 CFR 2520.104-24].

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* In certain cases, a severance plan will be considered a pension plan. See DOL Reg. 29 CFR 2510.3-2(b).

- Plans that have fewer than 100 participants at the beginning of the plan year, and—
  - (*1*) Pay benefits solely from the general assets of the employer or employee organization maintaining the plan, or (*2*) provide benefits exclusively through insurance contracts or policies issued by a qualified insurance company or through a qualified HMO, the premiums of which are paid directly out of the general assets of the employer or employee organization, or partly from general assets and partly from employee or member contributions, or (*3*) partly as in (*1*) and partly as in (*2*); *AND*
  - Forward any employee contributions to the insurance company within three months of receipt; *AND*
  - Pay any employee refunds to employees within three months of receipt [ref: DOL Reg. 29 CFR 2520.104-20].

General Exemption From Audit Requirement Only:

Plans, irrespective of the number of participants at the beginning of the plan year, that—

- (*1*) Pay benefits solely from the general assets of the employer or employee organization maintaining the plan, or (*2*) provide benefits exclusively through insurance contracts or policies issued by a qualified insurance company or through a qualified HMO, the premiums of which are paid directly out of the general assets of the employer or employee organization, or partly from general assets and partly from employee or member contributions, or (*3*) provide benefits partly from the general assets of the employer or employee organization and partly through insurance (for example, a stop-loss insurance policy purchased or owned by the plan); *AND*
- Forward any employee contributions to the insurance company within three months of receipt; *AND*
- Pay any employee refunds to employees within three months of receipt [ref: DOL Reg. 29 CFR 2520.104-44(b)(1)].

Plans Covered by IRC Sections 6058 and 6039D (Fringe Benefit Plans)

A.26 Most retirement and savings plans (for example, pension, profit-sharing, or stock bonus plans) are required to file a Form 5500 series return under IRC section 6058 as well as ERISA. According to Announcement 82-146, however, church plans that have not made a section 410(d) election and governmental plans are not required to file a return. IRC section 6039D requires employers sponsoring fringe benefit plans described in IRC sections 120 (group legal services), 125 (cafeteria), or 127 (educational assistance) to file an annual report. Although the Tax Reform Act of 1986 (TRA '86) added plans under IRC sections 79 (life insurance), 105 and 106 (accident and health), and 129 (dependent care assistance) to IRC section 6039D, Notice 90-24 suspended this reporting obligation for these plans until further notice. Some fringe benefit plans may be required to file a Form 5500 *only* because of section 6039D, and not because of any ERISA requirement (see footnote 77). This may be the case, for example, for a cafeteria plan that covers fewer than 100 participants. Once the IRS suspension under Notice 90-24 is lifted, it would also be the case for plans under section 79, and some plans under sections 105 or 106 that have fewer than 100 participants. No plan required to file a Form 5500 *solely* because of section 6039D is required to be audited, because only ERISA requires audits. It should be noted that fringe benefit plans may also be welfare benefit plans required to file annual reports under Title I of ERISA.

Cafeteria Arrangements (IRC Section 125 Plans)

A.27 Cafeteria arrangements do not have to be audited unless they also provide welfare benefits (for example, medical benefits), in which case, they must be audited under the above criteria (for example, a plan that has 100 or more participants and is funded through a trust). Cafeteria arrangements that do not provide welfare benefits must, however, file a Form 5500 pursuant to IRC section 6039D.

PWBA Technical Release 92-1

A.28 In June 1992, PWBA issued Technical Release 92-1 announcing the DOL's enforcement policy with respect to welfare benefit plans with participant contributions. Cafeteria plans described in section 125 of the Internal Revenue Code, may not be required to have an audit, if the participant contributions used to pay benefits have not been held in trust. An audit may also not be required for other contributory welfare benefit plans where participant contributions are applied to the payment of premiums and such contributions have not been held in trust. The enforcement policy stated in ERISA Technical Release 92-01 will continue to apply until the adoption of final regulations addressing the application of the trust and reporting requirements of Title I of ERISA to welfare plans that receive participant contributions. See exhibit 5-3, "Welfare Benefit Plans Audit Decision Flowchart" for further guidance.

Plans Excluded From Filing (This Does Not Apply to Fringe Benefit Plans)

A.29 Plans maintained only to comply with workers' compensation, unemployment compensation, or disability insurance laws are excluded from filing.

A.30 An unfunded excess benefit plan (section 3(36)) is excluded from filing.

A.31 A welfare benefit plan maintained outside the United States primarily for persons substantially all of whom are nonresident aliens (see footnote 77) is excluded from filing.

A.32 A pension benefit plan maintained outside the United States is excluded from filing if it is a qualified foreign plan within the meaning of IRC section 404A(e) that does not qualify for the treatment provided in IRC section 402(c) (see paragraph A.04*d* in this appendix).

A.33 A church plan not electing coverage under IRC section 410(d) or a governmental plan is excluded from filing.

A.34 An annuity arrangement described in 29 CFR 2510.3-2(f) is excluded from filing.

A.35 A welfare benefit plan as described in 29 CFR 2520.104-20 is excluded from filing. Such a plan has fewer than 100 participants as of the beginning of the plan year and generally is one of the following:

a. *Unfunded.* Benefits are paid as needed directly from the general assets of the employer or the employee organization that sponsors the plan.[83]

b. *Fully insured.* Benefits are provided exclusively through insurance contracts or policies, the premiums being paid directly by the employer or employee organization from its general assets or partly from its general assets and partly from contributions by its employees or members.

c. *A combination of unfunded and insured.* Benefits are provided partially as needed directly from the general assets of the employer or the employee organization that sponsors the plan and partially through insurance contracts or policies, the premiums being paid directly by the employer or employee organization from its general assets (see paragraph A.68*d* in this appendix).

A.36 An apprenticeship or training plan meeting all of the conditions specified in 29 CFR 2520.104-22 is excluded from filing (see paragraph A.68*f*).

A.37 An unfunded pension benefit plan or an unfunded or insured welfare benefit plan (*a*) whose benefits go only to a select group of management or highly compensated employees and (*b*) that meets the requirements of 29 CFR 2520.104-23 (including the requirement that a notification statement be filed with DOL) or 29 CFR 2520.104-24, respectively, is excluded from filing (see paragraphs A.68*g* and A.68*h*).

A.38 Day-care centers as specified in 29 CFR 2520.104-25 are excluded from filing (see paragraph A.68*i*).

A.39 Certain dues-financed welfare and pension plans that meet the requirements of 29 CFR 2520.104-26 and 2520.104-27 are excluded from filing (see paragraph A.68*j*).

A.40 A welfare plan that participates in a group insurance arrangement that files a Form 5500 on behalf of the welfare plan is excluded from filing (see 29 CFR 2520.104-43).

A.41 A simplified employee pension (SEP) described in IRC section 408(k) that conforms to the alternative method of compliance described in 29 CFR 2520.104-48 or -49 is excluded from filing. A SEP is a pension plan that meets certain minimum qualifications regarding eligibility and employer contributions (see paragraphs A.68*p* and A.68*q*).

Kinds of Filers

A.42 A *single employer plan* is a plan sponsored by one employer.[84]

A.43 A *plan for a controlled group of corporations or group of trades or businesses under common control* is a plan sponsored by a group defined in IRC sections 414(b) and (c). To file as such a plan, benefits must be payable to participants from the plan's total assets without regard to contributions by each participant's employer.

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[83] "Directly" means that the plan does not use a trust or separately maintained fund (including a Code section 501(c)(9) trust) to hold plan assets or to act as a conduit for the transfer of plan assets.

[84] If several employers participate in a program of benefits wherein the funds attributable to each employer are available only to pay benefits to that employer's employees, each employer must file as a sponsor of a single employer plan.

A.44 A *multiemployer plan* is a plan (*a*) in which more than one employer is required to contribute, (*b*) that is maintained pursuant to one or more collective bargaining agreements, and (*c*) that had not made the election under IRC section 414(f)(5) and ERISA section 3(37)(E).

A.45 A *multiple-employer plan* is a plan that involves more than one employer, is not one of the plans described in paragraphs A.43 and A.44, and includes only plans whose contributions from individual employers are available to pay benefits to all participants.[85] Participating employers do not file individually for these plans. Multiple-employer plans can be collectively bargained and collectively funded, but if covered by PBGC termination insurance, must have properly elected before September 27, 1981, not to be treated as a multiemployer plan under Code section 414(f)(5) or ERISA sections 3(37)(E) and 4001(a)(3).

A.46 Direct filing entities (DFEs) include common/collective trusts (CCTs), pooled separate accounts (PSAs), master trust investment accounts (MTIAs), 103-12 investment entities (103-12 IEs) and group insurance arrangements (GIAs). CCTs, PSAs, MTIAs and 103-12 IEs must generally comply with the Form 5500 instructions for large plan pension plans. GIAs must follow the instructions for large welfare plans.

A.47 A *group insurance arrangement* is an arrangement that provides welfare benefits to the employees of two or more unaffiliated employers (not in connection with a multiemployer plan nor a multiple employer collectively bargained plan), fully insures one or more welfare plans of each participating employer, and uses a trust (or other entity such as a trade association) as the holder of the insurance contracts and the conduit for payment of premiums to the insurance company. If such an arrangement files a Form 5500 in accordance with 29 CFR 2520.103-2, the welfare plans participating in the arrangement need not file a separate report.[86]

When to File

A.48 The plan administrator must file the annual report seven months after the end of a plan year, including a short plan year (any plan year less than twelve months). A plan year ends upon the date of the change in accounting period or upon the complete distribution of the assets of the plan.

A.49 A one-time extension of time up to two and one-half months may be granted for filing the annual report if Form 5558, *Application for Extension of Time to File Certain Employee Plan Returns*, is filed with the IRS before the normal due date of the report. In addition, single-employer plans and plans sponsored by a controlled group of corporations that file consolidated federal income tax returns are automatically granted an extension of time to file Form 5500 to the due date of the federal income tax return of the single employer or controlled group of corporations if certain conditions described in the instructions to the forms are met. A copy of the extension must be filed with the annual report.

Filing Under the Statute Versus the Regulations

A.50 As stated in A.17, plan administrators may, for purposes of Title I of ERISA, file an annual report containing all of the information required by ERISA section 103 (that is, the statute) or the information required by the

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[85] A separate schedule T, for each participating employer that provides pension benefits, must be attached to the plan's Form 5500.

[86] Also see 29 CFR 2520.104-21 and 2520.104-43.

regulations. As also noted in A.17, however, a filing in accordance with ERISA section 103 will not satisfy an administrator's annual reporting obligations under the IRC or Title IV of ERISA; the Form 5500 must be filed to comply with those requirements.

a. *Regulations*. Filing the Form 5500 is considerably different from filing by the statute. The regulations require that the accountant's report—

— Disclose any omitted auditing procedures deemed necessary by the accountant and the reasons for their omission.

— State clearly the accountant's opinion of the financial statements and schedules covered by the report and the accounting principles and practices reflected therein.

— State clearly the consistency of the application of the accounting principles between the current year and the preceding year or as to any changes in such principles which have a material effect on the financial statements.[87]

— State clearly any matters to which the accountant takes exception, the exception, and to the extent practical, the effect of such matters on the related financial statements. Exceptions are required to be further identified as (*a*) those that are the result of DOL regulations and (*b*) all others.[88]

The regulations also require (1) current value,[89] comparing the beginning and end of the plan year, (2) a description of accounting principles and practices reflected in the financial statements and, if applicable, variances from GAAP and an explanation of differences, if any, between the information contained in the separate financial statements and the net assets, liabilities, income, expense, and changes in net assets as required to be reported on the Form 5500.

b. *Statute*. In particular, a plan administrator electing to comply with the statute must satisfy all the requirements of ERISA section 103 and may not rely on regulatory exemptions and simplified methods of reporting or alternative methods of compliance prescribed with respect to the Form 5500. In addition, the statute requires (1) the accountant to express an opinion on whether the financial statements and ERISA section 103(b) schedules conform with generally accepted accounting principles on a basis consistent with that of the preceding year and (2) current value, comparing the end of the previous plan year and the end of the plan year being reported.

A.51 The statute and the regulations require that the examination be conducted in accordance with generally accepted auditing standards.

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[87] An accountant's report prepared in accordance with SAS No. 58, *Reports on Audited Financial Statements*, which prescribes that no reference be made to the consistent application of GAAP in those cases where there has been no accounting change, will be viewed as consistent with the requirements of ERISA and regulations issued thereunder with regard to the required submission of an accountant's report.

[88] Other requirements are that the report be dated, manually signed, and that it indicate the city and state where it is issued, and that it identify (without necessarily enumerating) the statements and schedules covered.

[89] "Current value," as used in this document, means fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary (as defined in section 402(a)(2)) pursuant to the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation at the time of such determination (section 3(26) of ERISA).

a. Financial information required under both methods includes plan assets and liabilities (aggregated by categories and valued at their current value with the same data displayed in comparative form using the end of the current plan year and either (1) the end of the previous plan year (statute) or (2) beginning of the current plan year (regulations), and information concerning plan income, expenses, and changes in net assets during the plan year).

b. Required supplemental information includes mandatory use of standardized schedules (Form 5500 schedule G) as follows (see paragraph A.75):

— Loans or fixed income obligations due in default or uncollectible.

— Leases in default or uncollectible.

— Nonexempt transactions.

Required information also include the following nonstandardized schedules:

— Assets held for investment purposes. If filing under the alternative method, a schedule of assets acquired and disposed of during the year is also required.

— Reportable transactions (that is, transactions that exceed 3 percent (statute) or 5 percent (regulations) of the current value of plan assets at the beginning of the year).[90]

c. Notes to the financial statements, when applicable, shall be provided concerning—

— A description of the plan, including significant changes in the plan and effect of the changes on benefits.

— The funding policy and changes in funding policy (including policy with respect to prior service cost), and any changes in such policies during the year (only applicable under the statutory method for pension plans).

— A description of material lease commitments and other commitments and contingent liabilities.

— A description of any agreements and transactions with persons known to be parties in interest.

— A general description of priorities in the event of plan termination.

— Whether a tax ruling or determination letter has been obtained.

— Any other information required for a fair presentation.

— An explanation of differences, if any, between the information contained in the separate financial statements and the net assets, liabilities, income, expense, and changes in net assets as required to be reported on the Form 5500, if filing under the alternative method (see paragraph A.50).

Investment Arrangements Filing Directly With DOL

A.52 Generally, when the assets of two or more plans are maintained in one trust or account or separately maintained fund, all annual report entries,

[90] Plans filing their annual reports under the statutory method are required to report transactions that exceed 3 percent of the fair value of plan assets at the beginning of the year, whereas plans that file pursuant to the alternative method of compliance prescribed in DOL regulations are required to report transactions that exceed 5 percent of the fair value of plan assets at the beginning of the year.

including any attached schedules, shall be completed by including the plan's allocable portion of the trust, account, or fund. Certain exceptions have been made, however, for plans that invest in certain investment arrangements that are either required to, or may elect to, file information concerning themselves and their relationship with employee benefit plans directly with DOL as discussed subsequently. Plans participating in these investment arrangements are required to attach certain additional information to the Form 5500 as specified below. For a definition of plan assets and the look-through provisions, see 29 CFR 2510.3-101.

Common/Collective Trusts and Pooled Separate Accounts

A.53 For reporting purposes, a common/collective trust (CCT) is a trust maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or a controlled group of corporations, as the term is used in IRC section 1563.

For reporting purposes, a pooled separate account (PSA) is an account maintained by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or controlled group of corporations, as that term is used in IRC section 1563.

Although CCTs and PSAs are not required to file directly with the Department of Labor, their filing or lack thereof directly affects the participating plan's filing responsibilities. If the CCT or PSA does elect to directly file, participating plans must:

a. File a Form 5500, completing items 1c(9) and items 2b(6) or (7) on Schedule H, "Financial Information," and

b. Complete Part I of Schedule D, "DFE/Participating Plan Information."

If the CCT or PSA does not file directly with the Department of Labor, plans participating in these arrangements must:

a. File a Form 5500, allocating and reporting the underlying assets of the CCT or PSA in the appropriate categories on a line by line basis on Part I of Schedule H, "Financial Information," and

b. Complete Part I of Schedule D, "DFE/Participating Plan Information."

CCTs and PSAs that elect to file directly with the Department of Labor must do so by filing a Form 5500, including Schedule D, "DFE/Participating Plan Information" and Schedule H, "Financial Information."

See paragraphs A.68*b* and A.68*c* and 29 CFR 2520.103-3, -4 and -5, and 2520.103-9.[91]

[91] For reporting purposes, a separate account that is not considered to be holding plan assets pursuant to 29 CFR 2510.3-101(h)(1)(iii) shall not constitute a pooled separate account.

Master Trust

A.54 For reporting purposes, a master trust is a trust for which a regulated financial institution serves as trustee or custodian (regardless of whether such institution exercises discretionary authority or control with respect to the management of assets held in the trust), and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.[92] Participating plans are required to complete item 1c(11) and item 2b(8) on Schedule H, "Financial Information," and Part I of Schedule D, "DFE/Participating Plan Information."

The following information is required to be filed by the plan administrator or by a designee directly with DOL no later than the date on which the plan's report is due. The plan's report will not be deemed complete unless all the information is filed within the prescribed time.

a. Form 5500.

b. A Schedule A, "Insurance Information" for each insurance or annuity contract held in the master trust (See paragraph A.69).

c. A Schedule C, "Service Provider Information," Part I, if the service provider was paid $5,000 or more. (See paragraph A.71).

d. A Schedule D, "DFE/Participating Plan Information," Part II. (See paragraph A.72).

e. A Schedule H, "Financial Information." (See paragraph A.76).

f. A Schedule G, "Financial Transaction Schedules." (See paragraph A.75).

See paragraph A.68*a* and 29 CFR 2520.103-1(e).

Plans Versus Trusts

A.55 Under ERISA, the audit requirement is applied to each separate plan and not each separate trust. As a result, each plan funded under a master trust arrangement is subject to a separate Form 5500 and audit requirement, unless otherwise exempt.

103-12 Investment Entities

A.56 For purposes of the annual report, entities described in the next paragraph that file the information directly with DOL as specified subsequently constitute "103-12 Investment Entities" (103-12 IEs).[93] Plans may invest in an entity, the underlying assets of which include "plan assets" (within the meaning of 29 CFR 2510.3-101) of two or more plans that are not members of a related group of employee benefit plans. For reporting purposes, a "related group" consists of each group of two or more employee benefit plans (*a*) each of which receives 10 percent or more of its aggregate contributions from the same employer or from a member of the same controlled group of corporations (as determined under IRC section 1563(a), without regard to IRC section 1563(a)(4) thereof); or (*b*) each of which is either maintained by, or maintained

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[92] A "regulated financial institution" means a bank, a trust company, or a similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency. Common control is determined on the basis of all relevant facts and circumstances.

[93] The plan administrator cannot use this alternative method of reporting unless the report of the investment entity has been submitted to DOL in accordance with the requirements specified in the Form 5500 and 5500-C/R instructions.

pursuant to, a collective bargaining agreement negotiated by the same employee organization or affiliated employee organizations. For purposes of this paragraph, an "affiliate" of an employee organization means any person controlling, controlled by, or under common control with such organization.

The following information for the fiscal year of the 103-12 IE ending with or within the plan year must be filed directly with DOL by the sponsor of the 103-12 IE no later than the date on which the plan's annual report is due before the plan administrator can elect the alternative method of reporting:

a. Form 5500.

b. A Schedule A, "Insurance Information" for each insurance or annuity contract held in the 103-IE (See paragraph A.69).

c. A Schedule C, "Service Provider Information," Part I, if the service provider was paid $5,000 or more, and Part II, if the accountant was terminated. (See paragraph A.71).

d. A Schedule D, "DFE/Participating Plan Information." (See paragraph A.72).

e. A Schedule H, "Financial Information." (See paragraph A.76).

f. A Schedule G, "Financial Transaction Schedules." (See paragraph A.75).

g. A report of an independent qualified public accountant (IQPA) regarding the above items and other books and records of the 103-12 IE that meets the requirements of 29 CFR 2520.103-1(b)(5).

See 29 CFR 2520.103-12 and A.84.

Limited-Scope Audit Exemption

A.57 Under DOL regulations, certain assets held by a bank, trust company, or similar institution or by an insurance company that is regulated and subject to periodic examination by a state or federal agency, and related information does not have to be audited provided the plan administrator exercises this option and the institution holding the assets certifies the required information. The limited-scope audit exemption does not exempt the plan from the requirement to have an audit.[94] All non-investment activity of the plan, such as contributions, benefit payments, and plan administrative expenses are subject to audit whether or not the assets of the plan have been certified as described above. See paragraphs 7.48 and 13.26 for limited-scope audit procedures and reporting.

A.58 The limited-scope audit exemption does not apply to assets held by a broker/dealer or an investment company. It also does not extend to benefit payment information [ref: DOL Reg. 29 CFR 2520.103-8; 2520.103-3; and 2520.103-4]. See paragraphs 7.52 and 13.26 through 13.30 for a discussion of the auditor's responsibilities when the scope of the audit is so restricted.

A.59 The Securities and Exchange Commission will not accept a limited-scope audit report in connection with a Form 11-K filing, even if the plan has elected to file financial statements that are prepared in accordance with the financial reporting requirements of ERISA. (See paragraph 12.20 for a further discussion of SEC reporting requirements.)

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[94] This limitation on the scope of an auditor's examination applies to plans sponsored by a "regulated" bank or insurance carrier for its own employees, as well as to other plans.

What to File (See Exhibit 3)

A.60 File Form 5500 annually for each plan required to file (see 29 CFR 2520.104a-5 and -6 and paragraphs A.29 through A.41 and A.61 through A.84).

A.61 Exception to A.60: If a plan has between 80 and 120 participants (inclusive) as of the beginning of the plan year, the plan may elect, instead of following paragraph A.60 to complete the current years return/report in the same category ("large plan" or "small plan") as was filed for the prior year. (See 29 CFR 2520.104a-5 and paragraph A.65).

A.62 File Form 5500EZ, *Annual Return of One-Participant Pension Benefit Plan*, annually for certain one-participant plans. For Form 5500EZ purposes, a *one-participant plan* is a pension benefit plan that covers only (*a*) an individual, or an individual and his or her spouse, who wholly owns a trade or business, whether incorporated or unincorporated; or (*b*) partners and/or the spouses of partners in a partnership. See the instructions to the Form 5500EZ to determine which one-participant plans must file.

A.63 Amended reports should be filed as appropriate; however, they must include an original signature of the plan administrator.

A.64 A final report is required when all assets under a pension plan (including insurance/annuity contracts) have been distributed to the participants and beneficiaries or distributed to another plan or when all liabilities for which benefits may be paid under a welfare benefit plan have been satisfied and all assets, if the plan is not unfunded, have been distributed. A final report is filed on the Form 5500.

Exemptions—Audit

A.65 "Small plans" having fewer than 100 participants as of the beginning of the plan year, as reported on Form 5500, item 6, need not engage an auditor for purposes of the annual report. "Large plans" generally must engage an auditor (see paragraphs A.23, A.60, A.61, A.84, and 29 CFR 2520.104-41 and 2520.104-46).

A.66 Plan years of seven months or less, due to: (1) initial year; (2) merger; or (3) change of plan year can generally postpone (but not eliminate) the audit requirement (but not the requirement to file a Form 5500) until the following year. This rule also applies when a full plan year is followed by a short plan year of seven months or less. The audit report would therefore cover both the short year and the full plan year [ref: DOL Reg. 29 CFR 2520.104-50].

Exemptions—Other Filing Requirements

A.67 Plans that are filing in a short plan year may defer the IQPA's report (see 29 CFR 2520.104-50).

A.68 The following is a list of variances, which modify the general annual reporting requirements:

a. 29 CFR 2520.103-1(e) provides the regulatory authority for the reporting of financial information by plans participating in a master trust (see paragraph A.54).

b. 29 CFR 2520.103-3 and -4 provide exemptions for plans some or all the assets of which are held in a common/collective trust of a bank or similar institution or a pooled separate account of an insurance carrier from reporting information concerning the individual transactions of the common/collective trusts and pooled separate accounts provided the conditions of the regulation are satisfied (see paragraph A.53).

c. 29 CFR 2520.103-9 permits the direct filing of financial information to the DOL by banks and insurance companies of information otherwise required to be submitted to IRS with the Form 5500 or 5500-C/R when plans hold units of participation in common/collective trusts or pooled separate accounts (see paragraph A.53).

d. 29 CFR 2520.104-20 provides a limited exemption for certain small welfare plans (see paragraphs A.35 and A.60).

e. 29 CFR 2520.104-21 provides a limited exemption for certain group insurance arrangements.

f. 29 CFR 2520.104-22 provides an exemption for apprenticeship and training plans (see paragraph A.36).

g. 29 CFR 2520.104-23 provides an alternative method of compliance for pension plans for certain selected employees (see paragraph A.37).

h. 29 CFR 2520.104-24 provides an exemption for welfare plans for certain selected employees (see paragraph A.37).

i. 29 CFR 2520.104-25 provides an exemption for day-care centers (see paragraph A.38).

j. 29 CFR 2520.104-26 provides a limited exemption for certain dues-financed welfare plans maintained by employee organizations (see paragraph A.39).

k. 29 CFR 2520.104-27 provides a limited exemption for certain dues-financed pension plans maintained by employee organizations.

l. 29 CFR 2520.104-41 prescribes simplified annual reporting requirements for plans with fewer than 100 participants (see paragraph A.61).

m. 29 CFR 2520.104-43 provides an exemption from annual reporting requirements for certain group insurance arrangements (see paragraph A.40).

n. 29 CFR 2520.104-44 provides a limited exemption and alternative method of compliance for the annual report of certain unfunded and insured plans (see paragraphs A.57 through A.60).[95]

o. 29 CFR 2520.104-46 provides a waiver of examination and report of an auditor for plans with fewer than 100 participants (see paragraph A.61).

p. 29 CFR 2520.104-47 provides a limited exemption and alternative method of compliance for filing of insurance company financial reports (see section 103(e)).

q. 29 CFR 2520.104-48 provides an alternative method of compliance for Model Simplified Employee Pensions (see paragraph A.41).

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[95] For purposes of 29 CFR 2520.104-44, a contract is considered to be "allocated" only if the insurance company or organization that issued the contract unconditionally guarantees, upon receipt of the required premium or consideration, to provide a retirement benefit of a specified amount, without adjustment for fluctuations in the market value of the underlying assets of the company or organization, to each participant, and each participant has a legal right to such benefits that is legally enforceable directly against the insurance company or organization.

r. 29 CFR 2520.104-49 provides an alternative method of compliance for certain simplified employee pensions (see paragraph A.41).

Schedules

A.69 Schedule A, *Insurance Information*, must be attached to Form 5500 if any benefits under the plan are provided by an insurance company, insurance service, or other similar organization (such as Blue Cross, Blue Shield, or a health maintenance organization) (see paragraphs A.54, A.56, and A.60).

A.70 Schedule B, *Actuarial Information*, must be attached to Forms 5500 or 5500EZ for most defined benefit pension plans (see paragraph A.60).

A.71 Schedule C, *Service Provider Information*, must be attached to Form 5500. (See paragraphs A.54, A.56, A.60, and A.83).

A.72 Schedule D, *DFE / Participating Plan Information*, must be attached to Form 5500 for DFE filings and for plans participating in a DFE.

A.73 Schedule E, *ESOP Annual Information*, must be attached to Form 5500 if the plan is an ESOP.

A.74 Schedule F, *Fringe Benefit Plan Information*, must be attached to Form 5500 filed for fringe benefit plans required to file under code section 6039D.

A.75 Schedule G, *Financial Transaction Schedules*, must be attached to Form 5500 to report certain supplemental information.

A.76 Schedule H, *Large Plan and DFE Financial Information*, must be attached to Form 5500 for employee benefit plans that covered 100 or more participants as of the beginning of the plan year, and for DFE filings.

A.77 Schedule I, *Small Plan Financial Information*, must be attached to Form 5500 for employee benefit plans that covered less than 100 participants as of the beginning of the plan year.

A.78 Schedule P, *Annual Return of Fiduciary of Employee Benefit Trust*, must be attached to Forms 5500 and 5500EZ for the plan year in which the trust year ends for any fiduciary (trustee or custodian) of an organization that is qualified under IRC section 401(a) and exempt from tax under IRC section 401(a) who wants to protect the organization under the statute of limitations provided in IRC section 6501(a) (see paragraphs A.60 through A.62).

A.79 Schedule R, *Retirement Plan Information*, must be attached to Form 5500 for both tax qualified and nonqualified pension benefit plans.

A.80 Schedule T, *Qualified Pension Plan Coverage Information*, must be attached to Form 5500 for pension benefit plans that are intended to be qualified under code section 401(a) or 403(a). More than one Schedule T may be required.

A.81 Schedule SSA, *Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits*, must be attached to Form 5500 if the plan had any separated participants that must be reported in accordance with the schedule SSA instructions (see paragraphs A.54, A.56, and A.60).

A.82 Additional separate schedules must be attached to Form 5500 only in accordance with the instructions to the form and must always clearly reference the item number that requires this information (see Exhibit A-1).

Termination of Accountant or Actuary

A.83 Terminations of certain service providers must be reported in Part II of Schedule C, which is attached only to the Form 5500, and when applicable, to master trust and 103-12 IE reports. In addition, the plan administrator is required to provide terminated accountants and actuaries with a copy of the explanation for the termination as reported on Schedule C and a notice stating that the terminated party has the opportunity to comment directly to the DOL concerning the explanation (see paragraphs A.60 and A.71).

103-12 IEs

A.84 If a plan's assets include assets of a 103-12 investment entity, the examination and report of an independent qualified public accountant required by 29 CFR 2520.103-1 need not extend to such assets, if the entity reports directly to DOL pursuant to 29 CFR 2520.103-12 and the instructions to the Form 5500. Under 29 CFR 2520.103-12, the entity is required to include the report of an IQPA.

Independence of Independent Qualified Public Accountants

A.85 ERISA section 103(a)(3)(A) requires that the accountant retained by an employee benefit plan be "independent" for purposes of examining plan financial information and rendering an opinion on the financial statements and schedules required to be contained in the annual report. Under this authority DOL will not recognize any person as an auditor who is in fact not independent with respect to the employee benefit plan upon which that accountant renders an opinion in the annual report.

DOL has issued guidelines (29 CFR 2509.75-9) for determining when an auditor is independent for purposes of auditing and rendering an opinion on the annual report. For example, an accountant will not be considered independent with respect to a plan if—

a. During the period of professional engagement to examine the financial statements being reported, at the date of the opinion, or during the period covered by the financial statements the accountant or his or her firm or a member thereof—

- — Had, or was committed to acquire, any direct financial interest or any material indirect financial interest in the plan or plan sponsor;
- — Was connected as a promoter, underwriter, investment advisor, voting trustee, director, officer, or employee of the plan or plan sponsor except that a firm will not be deemed not independent if a former officer or employee of the plan or plan sponsor is employed by the firm and such individual has completely disassociated himself or herself from the plan or plan sponsor and does not participate in auditing financial statements of the plan covering any period of his or her employment by the plan or plan sponsor.

b. An accountant or a member of an accounting firm maintains financial records for the employee benefit plan.

However, an auditor may permissibly engage in or have members of his or her firm engage in certain activities that will not have the effect of removing recognition of independence. For example, an accountant will not fail to be recognized as independent if—

c. At or during the period of his or her professional engagement the accountant or his or her firm is retained or engaged on a professional basis by the plan sponsor. However, the accountant must not violate the prohibitions in (*a*) and (*b*) preceding.

d. The rendering of services by an actuary associated with the accountant or his or her firm shall not impair the accountant's or the firm's independence. The auditor should ensure that the provision of these services complies with the prohibited transaction rules of ERISA section 406(a)(1)(c).

Penalties

A.86 ERISA and the IRC provide for the assessment or imposition of penalties for failures to comply with the reporting and disclosure requirements.

Annual Reporting Penalties

A.87 One or more of the following penalties may be imposed or assessed in the event of a failure or refusal to file reports in accordance with the statutory and regulatory requirements:

a. Up to $1,100 a day for each day a plan administrator fails or refuses to file a complete annual report (see ERISA section 502(c)(2) and 29 CFR 2560.502c-2).

Perfection Penalties for Deficient Filings

Presently the Department assesses penalties of; *(1)* $150 a day (up to $50,000) per annual report filing where the required auditor's report is missing; *(2)* $100 a day (up to $36,500) per annual report filing that contains deficient financial information (for example, missing required supplemental schedules); and *(3)* $10 a day (up to $3,650) for information required on the Form 5500 Series reports (i.e. failure to answer a question).

Non-Filer and Late Filer Penalties

Presently the Department assesses non-filer penalties of $300 per day, up to $30,000 per annual report, per year. Late filer penalties are assessed at $50 per day.

Egregious Penalties may be assessed in addition to other penalty amounts.

b. $25 a day (up to $15,000) for not filing returns for certain plans of deferred compensation, certain trusts and annuities, and bond purchase plans by the due dates(s) (see IRC section 6652(e)). This penalty also applies to returns required to be filed under IRC section 6039D.

c. $1 a day (up to $5,000) for each participant for whom a registration statement (Schedule SSA (Form 5500)) is required but not filed (see IRC section 6652(d)(1)).

d. $1 a day (up to $1,000) for not filing a notification of change of status of a plan (see IRC section 6652(d)(2)).

e. $1,000 for not filing an actuarial statement (see IRC section 6692).

These penalties may be waived or reduced if it is determined that there was reasonable cause for the failure to comply.

A.88 The following are other penalties:

a. Any individual who willfully violates any provision of Part 1 of Title I of ERISA shall be fined not more than $5,000 or imprisoned not more than one year or both (see ERISA section 501).

b. A penalty up to $10,000, five years imprisonment, or both, for making any false statement or representation of fact, knowing it to be false, or for knowingly concealing or not disclosing any fact required by ERISA (see section 1027, Title 18, U.S.C., as amended by ERISA section 111).

c. Any employer maintaining a plan who fails to meet the notice requirement of section 101(d) with respect to any participant or beneficiary may in the court's discretion be liable to such participant or beneficiary in the amount of up to $100 a day from the date of such failure, and the court may in its discretion order such other relief as it deems proper (see ERISA section 502(c)(3)).

d. Civil penalties may be assessed against parties in interest or disqualified persons who engage in prohibited transactions (see ERISA section 502(i). There is also an excise tax for prohibited transactions under IRC section 4975).

e. ERISA section 502(l) requires a civil penalty to be assessed by the Secretary of Labor against a fiduciary who breaches his or her fiduciary duty or commits a violation of Part 4 of Title I or any other person who knowingly participates in such breach or violation. The civil penalty is 20 percent of the amount recovered pursuant to a settlement agreement with the Secretary or ordered to be paid by a court.[96]

Fiduciary Responsibilities (ERISA Sections 401 Through 414)

A.89 ERISA establishes standards for plan investments and transactions and imposes restrictions and responsibilities on plan fiduciaries.

A.90 A fiduciary's responsibilities include managing plan assets solely in the interest of participants and beneficiaries (with the care a prudent person would exercise) and diversifying investments to minimize the risk of large losses unless it is clearly not prudent to do so (see ERISA section 404). Plans are prohibited from acquiring or holding employer securities that are not qualifying employer securities (QES) or employer real property that is not qualifying employer real property (QERP). Furthermore, plans (other than certain individual account plans) may not acquire any QES or QERP if immediately after such acquisition the aggregate fair market value of QES and QERP held by the plan exceeds 10 percent of the assets of the plan (see ERISA section 407).

[96] An accountant who knows about a fiduciary breach or violation but chooses not to disclose it may knowingly participate in a breach or violation for purposes of section 502(l).

A.91 A plan fiduciary is prohibited from causing the plan to engage in certain transactions with a party in interest (see ERISA section 406).[97] The following transactions between a plan and a party in interest are generally prohibited (see ERISA section 406):

a. A sale, exchange, or lease of property, except to the extent allowed

b. A loan or other extension of credit

c. The furnishing of goods, services, or facilities, except as allowed under ERISA

d. A transfer of plan assets to a party in interest for the use or benefit of a party in interest

e. An acquisition of employer securities or real property, except to the extent allowed (see ERISA section 408(e))

However, conditional exemptions from the application of these provisions are provided by ERISA.

A.92 A fiduciary is also generally prohibited from using the plan assets for his or her own interest or account, acting in any plan transactions on behalf of a party whose interests are adverse to those of the plan or its participants, and receiving consideration for his or her own account from a party dealing with the plan in connection with a transaction involving the plan assets (see ERISA section 406(b)).

A.93 ERISA section 408 provides for exceptions to the rules on prohibited transactions. Section 408(a) gives authority to the Secretary of Labor to grant administrative exemptions from the prohibited transaction restrictions of ERISA sections 406 and 407. Sections 408(b), (c), and (e) provide statutory exemptions from the prohibited transaction rules for various transactions, provided the conditions specified in the statutory exemptions are satisfied. For example, reasonable arrangements can be made with a party in interest to provide services if the one who selects and negotiates with the service provider on behalf of the plan is independent of the service provider. Advice of legal counsel should be obtained when investigating a possible prohibited transaction or a possible breach of fiduciary duty.

A.94 A fiduciary must make good any losses to the plan resulting from a breach of fiduciary duty and must return to the plan any profits he or she made through the use of plan assets (see ERISA section 409).

Plan Termination Insurance

A.95 The insurance provisions under Title IV of ERISA, as amended, apply to qualified, defined benefit pension plans, with certain statutory exceptions, and do not apply to defined contribution plans (see ERISA section 4021).

A.96 The PBGC's termination insurance program is funded in part through premiums paid to the PBGC. The designated payor must make annual premium payments to the PBGC (see ERISA section 4007). For this purpose, the designated payor for a single employer plan is the contributing sponsor or

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[97] ERISA defines a party in interest generally as any fiduciary or employee of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee association whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee association, or a relative of a person described in the foregoing (see ERISA section 3(14)).

the plan administrator. The designated payor for a multiemployer plan is the plan administrator. For single employer plans, premiums are based on the number of participants in a plan and the amount by which the plan's benefits are underfunded (see ERISA section 4006). Premiums for multiemployer plans are based solely on the number of participants in the plan. In general, premiums may be paid by the contributing sponsor or by plan funds, whichever is permitted under the terms of the plan; however, premiums for a plan that is undergoing a distress termination or an involuntary termination must be paid by the contributing sponsor (see 29 CFR 2610.26). Each member of the contributing sponsor's controlled group, if any, is jointly and severally liable for the required premiums (see ERISA section 4007).

A.97 A plan administrator or contributing sponsor must notify the PBGC when a "reportable event" such as bankruptcy of the contributing sponsor or inability of the plan to pay benefits occurs (see ERISA sections 4041(c) and 4043; 29 CFR Part 2615). Each person who is a contributing sponsor of a single employer pension plan is responsible for quarterly contributions required to meet the minimum funding standards (see ERISA section 302(e)). If the contributing sponsor is a member of a controlled group, each person who is also a member of the controlled group is jointly and severally liable for the contributions (see ERISA section 302(c)(11)). Failure to make the required contributions may result in a lien upon all property and property rights belonging to such persons, which lien may be enforced by the PBGC. ERISA provides for two types of single employer plan terminations: a standard termination and a distress termination (ERISA section 4041). A plan may be terminated voluntarily in a standard termination only if it can pay all benefit liabilities under the plan. A plan may be terminated in a distress termination only if the contributing sponsor and each member of the contributing sponsor's controlled group meet the necessary distress criteria (for example, undergoing liquidation). In either type of termination, an enrolled actuary's certification of the value of the plan's assets and benefits must be filed with the PBGC. When an underfunded single employer plan terminates in a distress termination, the contributing sponsor and each member of the contributing sponsor's controlled group are liable to the PBGC for the total amount of unfunded benefit liabilities and the total amount of unpaid minimum funding contributions and applicable interest (see ERISA section 4062). If an employer that contributes to a multiemployer plan withdraws from the plan in a complete or partial withdrawal, the employer is generally liable to the plan for an allocable share of the unfunded vested benefits of the plan (see ERISA section 4201).

Administration and Enforcement (ERISA Sections 501 Through 514)

A.98 Responsibility for administration of ERISA and enforcement of its provisions rests primarily with the IRS and the DOL. The agencies are empowered to bring suit in federal court in civil actions, criminal actions, or both.

A.99 Failure to meet ERISA's requirements can result in the imposition of substantial fines, excise taxes, and other penalties, including possible loss of tax-exempt status. Although ERISA states that the plan is subject to certain of the penalties, the penalties are likely to fall not on the plan but on the sponsoring employer because Congress, in formulating ERISA, sought to protect plan assets for participants and their beneficiaries, not to protect employers from liability (see paragraphs A.87 and A.88).

A.100 ERISA was intended to generally supersede state laws relating to employee benefit plans. Thus, plans subject to Title I of ERISA or Title IV of ERISA are generally not subject to state regulation. Preemption of state laws does not extend, however, to generally applicable criminal statutes or laws regulating insurance, banking, or securities.

A.101 Plans that are multiple employer welfare arrangements (MEWAs) may also be subject to state or local regulation even if the MEWA is also an employee benefit plan covered under Title I of ERISA. A MEWA is any employee welfare benefit plan or other arrangement that provides benefits to the employees of two or more employers but does not include arrangements maintained under or pursuant to one or more collective bargaining agreements, by a rural electric cooperative, or by two or more trades or businesses within the same control group (see ERISA section 3(40)). If the MEWA is a fully insured plan covered by Title I of ERISA, the state government may only provide standards requiring specified levels of reserves and specified levels of contributions adequate to be able to pay benefits in full when due. If the MEWA is a plan covered by Title I that is not fully insured, any law of a state regulating insurance may apply to the extent that it is not inconsistent with the provisions of Title I of ERISA.

Exhibit A-1

Examples of Form 5500 Schedules Required By the Regulations [Not Permitted If Filing By the Statutory Method]

The new 1999 Form 5500 continues to require that certain supplemental schedules be attached to the annual Form 5500 filing. The information reported in these schedules have not changed from prior years. However, reporting has now been standardized in that some of these schedules are now required to be reported on Schedule G, "Financial Transactions Schedules" of Form 5500 as noted below.

The following schedule is the "Schedule of Assets Held for Investment Purposes At End of Year." In column (a), place an asterisk (*) on the line of each identified person known to be a party in interest to the plan. The schedule must use the format shown below and be clearly labeled, "Schedule of Assets Held for Investment Purposes At End of Year."

(a)	(b) Identity of issue, borrower, lessor or similar party	(c) Description of investment including maturity date, rate of interest, collateral, par, or maturity value	(d) Cost+	(e) Current value++

Note 1: Participant loans may be aggregated and presented with a general description of terms and interest rates.

Note 2: In column (d), cost information may be omitted with respect to participant or beneficiary directed transactions under an individual account plan.

The following schedule is the "Schedule of Investment Assets Both Acquired and Disposed of Within the Plan Year" (see 2520.103-11). This schedule must be clearly labeled, "Schedule of Investment Assets Both Acquired and Disposed of Within the Plan Year" and must use the following format:

(a) Identity of issue, borrower, lessor or similar party	(b) Description of investment including maturity date, rate of interest, collateral, par, or maturity value	(c) Costs of acquisitions	(d) Proceeds of dispositions

Note: In column (c), cost information may be omitted with respect to participant or beneficiary directed transactions under an individual account plan.

The following schedule is the "Schedule of Reportable Transactions." This schedule must be clearly labeled, "Schedule of Reportable Transactions" and must use the following format:

(a) Identity of party involved	(b) Description of asset (include interest rate and maturity in case of a loan)	(c) Purchase price	(d) Selling price	(e) Lease rental	(f) Expense incurred with transaction	(g) Cost of asset+	(h) Current value of asset on transaction date++	(i) Net gain or (loss)

Note: Participant or beneficiary directed transactions under an individual account plan should not be taken into account for purposes of preparing this schedule. The current value of all assets of the plan, including those resulting from participant direction, should be included in determining the 5% figure for all other transactions.

The following schedule is the "Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible." **This schedule is now required to be reported in Schedule G, Part I of the Form 5500.** In column (a), place an asterisk (*) on the line of each identified person known to be a party in interest to the plan. Include all loans that were renegotiated during the plan year. Also, explain what steps have been taken or will be taken to collect overdue amounts for each loan listed. The following are the headings of Schedule G, Part I:

			Amount received during reporting year				Amount overdue	
(a)	(b) Identity and address of obligor	(c) Original amount of loan	(d) Principal	(e) Interest	(f) Unpaid balance at end of year	(g) Detailed description of loan including dates of making and maturity, interest rate, the type and value of collateral, any renegotiation of the loan and the terms of the renegotiation and other material items	(h) Principal	(i) Interest

The next schedule is the "Schedule of Leases in Default or Classified as Uncollectible." **This schedule is now required to be reported in Schedule G, Part II of the Form 5500.** In column (a), place an asterisk (*) on the line of each identified person known to be a party in interest to the plan. The following are the headings of Schedule G, Part II:

(a)	(b) Identity of lessor/ lessee	(c) Relationship to plan, employer, employee organization or other party-in-interest	(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)	(e) Original cost	(f) Current value at time of Lease	(g) Gross rental receipts during the plan year	(h) Expenses paid during the plan year	(i) Net Receipts	(j) Amount in arrears

The last schedule is the schedule of "Nonexempt Transactions." **This schedule is now required to be reported in Schedule G, Part III of the Form 5500.** The following are the headings of Schedule G, Part III:

(a) Identity of party involved	(b) Relationship to plan, employer or other party-in- interest	(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value	(d) Purchase price	(e) Selling price	(f) Lease rental	(g) Expenses incurred in connection with transaction	(h) Cost of asset+	(i) Current value of asset++	(j) Net gain or (loss) on each transaction

+ *Cost or Cost of Asset* refers to the original or acquisition cost of the asset. The DOL generally will accept any clearly defined and consistently applied method of determining historical cost that is based on the initial acquisition cost of the asset (e.g. first in-first out or average cost). The use of revalued cost (the fair value of the asset at the beginning of the current plan year) for these schedules is not acceptable.

++ *Current Value* means fair market value where available. Otherwise, it means the fair value as determined in good faith under the terms of the plan by a trustee or a named fiduciary, assuming an orderly liquidation at the time of the determination.

Exhibit A-2

Pension and Welfare Benefit Admin., Labor **Part 2520**

SUBCHAPTER C—REPORTING AND DISCLOSURE UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2520—RULES AND REGULATIONS FOR REPORTING AND DISCLOSURE

Authority: Secs. 101, 102, 103, 104, 105, 109, 110, 111(b)(2), 111(c), and 505, Pub. L. 93-406, 88 Stat. 840-52 and 894 (29 U.S.C. 1021-25, 1029-31, and 1135); Secretary of Labor's Order No. 27-74, 13-76, 1-87, and Labor Management Services Administration Order No. 2-6.

Exhibit A-3

QUICK REFERENCE CHART FOR FILING THE NEW FORM 5500[1]

	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan	DFE[2]	Fringe Benefit Plan
Schedule A (Insurance Information)	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts.	Must complete if MTIA, 103-12 IE or GIA has insurance contracts.	**Not required.**
Schedule B (Actuarial Information)	Must complete if defined benefit plan and subject to minimum funding standards.	Must complete if defined benefit plan and subject to minimum funding standards.	**Not required.**	**Not required.**	**Not required.**	**Not required.**
Schedule C (Service Provider Information)	Must complete if service provider was paid $5,000 or more and/or an accountant or actuary was terminated.	**Not required.**	Must complete if service provider was paid $5,000 or more and/or an accountant or actuary was terminated.	**Not required.**	MTIAs, GIAs and 103-12 IEs must complete Part I if service provider paid $5,000 or more. GIAs and 103-12 IEs must complete Part II if accountant was terminated.	**Not required.**
Schedule D (DFE/ Participating Plan Information)	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	All DFEs must complete Part II, and DFEs that invest in CCT, PSA, or 103-12 IE must also complete Part I.	**Not required.**
Schedule E (ESOP Information)	Must complete if ESOP.	Must complete if ESOP.	**Not required.**	**Not required.**	**Not required.**	**Not required.**

[1] This chart provides only general guidance. Not all rules and requirements are reflected. Refer to specific Form 5500 instructions and regulations for complete information.

[2] DFE (Direct Filing Entity) includes: bank common or collective trusts (CCTs) and insurance company pooled separate accounts (PSAs)(29 CFR 2520.103-3 and 103-4) that choose to file information on behalf of their participating plans; master trust investment accounts (MTIAs)(29 CFR 2520.103-1(e); investment entities filing under 29 CFR 2520.103-12 (103-12 IEs); and group insurance arrangements (GIAs) filing under 29 CFR 2520.103-2 and 104-43.

QUICK REFERENCE CHART FOR FILING THE NEW FORM 5500[1]—continued

	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan	DFE[2]	Fringe Benefit Plan
Schedule F (Fringe Benefit Plan Information)	**Not required.**	**Not required.**	**Not required.**	**Not required.**	**Not required.**	Must complete.
Schedule G (Financial Schedules)	Must complete if Schedule H, lines 4b, 4c, or 4d are "Yes."[3]	**Not required.**	Must complete if Schedule H, lines 4b, 4c, or 4d are "Yes."3, 4	**Not required.**	MTIAs, GIAs and 103-12 IEs must complete if Schedule H, lines 4b, 4c, or 4d are "Yes."[3]	**Not required.**
Schedule H (Large Plan and DFE Financial Information)	Must complete.	**Not required.**	Must complete.[4]	**Not required.**	All DFEs must complete Parts I, II & III. MTIAs, 103-12 IEs, and GIAs must also complete Part IV.	**Not required.**
Schedule I (Small Plan Financial Information)	**Not required.**	Must complete.	**Not required.**	Must complete.[4]	**Not required.**	**Not required.**
Schedule P (Annual Return of Fiduciary)	Must file to start running of statute of limitations under Code section 6501(a).	Must file to start running of statute of limitations under Code section 6501(a).	**Not required.**	**Not required.**	**Not required.**	**Not required.**

[1] This chart provides only general guidance. Not all rules and requirements are reflected. Refer to specific Form 5500 instructions and regulations for complete information.

[2] DFE (Direct Filing Entity) includes: bank common or collective trusts (CCTs) and insurance company pooled separate accounts (PSAs)(29 CFR 2520.103-3 and 103-4) that choose to file information on behalf of their participating plans; master trust investment accounts (MTIAs)(29 CFR 2520.103-1(e); investment entities filing under 29 CFR 2520.103-12 (103-12 IEs); and group insurance arrangements (GIAs) filing under 29 CFR 2520.103-2 and 104-43.

[3] Schedules of assets and reportable (5%) transactions also must be filed with the Form 5500 if Schedule H, lines 4i or 4j are "Yes," but use of scannable form not required.

[4] Unfunded, fully insured and combination unfunded/insured welfare plans covering fewer than 100 participants at the beginning of the plan year that meet the requirements of 29 CFR 2520.104-20 are exempt from filing an annual report. Such a plan with 100 or more participants must file an annual report, but is exempt under 29 CFR 2520.104-44 from the accountant's report requirement and completing Schedule H, but MUST complete Schedule G, Part III, to report any nonexempt transactions.

QUICK REFERENCE CHART FOR FILING THE NEW FORM 5500[1]—continued

	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan	DFE[2]	Fringe Benefit Plan
Schedule R (Retirement Plan Information)	Must complete unless plan is neither a defined benefit plan nor subject to Code section 412 or ERISA section 302 and no benefits were distributed during the plan year.	Must complete unless plan is neither a defined benefit plan nor subject to Code section 412 or ERISA section 302 and no benefits were distributed during the plan year.	Not required.	Not required.	Not required.	Not required.
Schedule SSA (Statement Identifying Separated Participants With Deferred Vested Benefits)	Must complete if plan had separated participants with deferred vested benefits to report.	Must complete if plan had separated participants with deferred vested benefits to report.	Not required.	Not required.	Not required.	Not required.
Schedule T (Qualified Pension Plan Information)	Must complete if qualified plan unless permitted to rely on coverage testing information for prior year.	Must complete if qualified plan unless permitted to rely on coverage testing information for prior year.	Not required.	Not required.	Not required.	Not required.
Accountant's Report	Must attach.	Not required.	Must attach.	Not required.	Must attach for a GIA or 103-12 IE.	Not required.

[1] This chart provides only general guidance. Not all rules and requirements are reflected. Refer to specific Form 5500 instructions and regulations for complete information.

[2] DFE (Direct Filing Entity) includes: bank common or collective trusts (CCTs) and insurance company pooled separate accounts (PSAs)(29 CFR 2520.103-3 and 103-4) that choose to file information on behalf of their participating plans; master trust investment accounts (MTIAs)(29 CFR 2520.103-1(e); investment entities filing under 29 CFR 2520.103-12 (103-12 IEs); and group insurance arrangements (GIAs) filing under 29 CFR 2520.103-2 and 104-43.

Exhibit A-4

Special Rules

"Plan Assets"—Plan Investments

DOL Regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity (other than common or collective trusts, pooled separate accounts, and master trusts), the underlying assets of which include "plan assets" (within the meaning of DOL Reg. 29 CFR 2510.3-101) of two or more plans that are not members of a "related group" of employee benefit plans. For reporting purposes, these investment entities (commonly referred to as 103-12 Investment Entities) are required to provide certain information directly to DOL for the fiscal year of the entity ending with or within the plan year for which the plan's annual report is made. This information includes the report of an independent qualified public accountant regarding the *statements* and *schedules* described in DOL Reg. 29 CFR 2520.103-12(b)(2)-(5), which meets the requirements of DOL Reg. 29 CFR 2520.103-1(b)(5).

Fringe Benefit Plans

Fringe benefit plans are employer-sponsored arrangements required to file the information specified by IRC section 6039D in accordance with the instructions to the Form 5500 (see footnote 76). It should be noted that fringe benefit plans may also be welfare benefit plans required to file annual reports under Title I of ERISA.

Welfare Benefit Plans

Under ERISA, according to DOL Regulation 29 CFR 2510.3-1, a welfare plan provides medical, surgical, or hospital benefits, or benefits in event of sickness, accident, disability, death, or unemployment, or vacation benefits, apprenticeship or training programs, or day-care centers (distinct from dependent care assistance programs), scholarship funds, prepaid legal services and certain benefits under the Labor Management Relations Act of 1947. Plan sponsors have a great degree of discretion regarding the number of benefits provided through one welfare benefit plan.

Appendix B

Examples of Controls

B.01 This appendix provides guidance for the use of service organization reports (SAS No. 70 reports) and gives examples of selected controls for employee benefit plans (Exhibit B-1). The controls included are related to specific control objectives that may be relevant to an audit of a plan's financial statements and, accordingly, control activities concerning the effectiveness, economy, and efficiency of certain management decision-making processes are not included. The examples are not intended to be all-inclusive or to suggest the specific objectives and controls that should necessarily be adopted by employee benefit plans. Some of the illustrated control objectives may not be relevant to particular plans because of the type of plan or the absence of certain types of transactions. When using the objectives in Exhibit B-1, auditors may find it useful to keep in mind the assertions set forth in SAS No. 31, *Evidential Matter*, as amended. SAS No. 31 says that when obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. The assertions are listed as existence/occurrence, completeness, rights and obligations, valuation/allocation, and presentation and disclosure. Exhibit B-1 references the chapters in this Guide where suggested auditing procedures can be found for each of the control objectives identified.

B.02 Many SAS No. 70 reports include a list of controls that should be in place at the user organization. If effective user controls are not in place, the service organization controls may not compensate for such weaknesses. The user auditor may need to test the user organization controls to ensure that they are in place. Exhibit B-2 provides examples of user controls that might be implemented when significant plan operations are performed by a service organization.

Exhibit B-1

Examples of Selected Controls for Employee Benefit Plans

Investments:	
Specific Objectives	*Examples of Selected Controls*
Investment transactions are recorded at the appropriate amounts and in the appropriate periods on a timely basis. (Chapter 7—*Auditing Investments*)[1]	• Reports submitted by trustees/asset custodians or investment managers are reviewed. • Detailed subsidiary records are reconciled to trust reports on a regular basis. • Control totals from participant's records are compared to control totals from trust reports on a regular basis. Report of trustee's/asset custodian's independent auditor is reviewed. • Purchases and Sales (as a result of contributions, distributions, etc.) of mutual funds are reviewed to determine that the net asset value agrees to published quotations. • Purchases and Sales are reviewed to determine that the appropriate fair value was utilized .
Investment income and expenses are recorded at the appropriate amount and in the appropriate period on a timely basis. (Chapter 7)	• Commissions and management fees are reviewed for appropriateness and adherence to the contract. • Interest, dividends, and other sources of income, including securities lending fees, are reviewed for receipt and for accuracy by reference to reliable sources. • If income is allocated to more than one plan or participant accounts, allocation methods and calculations are reviewed.

1 All chapter references in this appendix refer to where suggested auditing procedures for such objective can be found in this Guide.

Specific Objectives	*Examples of Selected Controls*
Investments (other than insurance contracts with insurance companies and fully benefit responsive investment contracts held by defined contribution pension and health and welfare plans) are measured at fair value. (Chapter 7)	• Quotation sources and appraisal reports are compared with recorded values. • Pooled separate accounts and common collective trusts are compared to net asset values calculated by the issuer. • Financial statements of pooled separate accounts and common collective trusts are obtained and unit information contained in the financial statements is compared for reasonableness to the unit values reported to the plan. • Valuation methods are documented in the trust agreement or plan committee minutes. • Basis for "good faith" estimates including independent appraisals, if any, is documented. • "Good faith" estimates are approved by plan committee.
Premiums and interest relating to insurance contracts are recorded at the appropriate amount and in the appropriate period on a timely basis. (Chapter 7)	• Premium statements are compared with insurance contracts. • Interest amount calculation is tested. • List of current participants is reviewed.
Investment criteria and objectives are authorized and executed in accordance with formal authorizations. (Chapter 7)	• Investment criteria or objectives are documented in the plan instrument or plan committee minutes. • Authority to execute transactions is specified in the plan instrument or plan committee minutes. • Investment transactions are reviewed by a plan committee for adherence to investment guidelines.

Investments: *(cont'd)*

Specific Objectives	*Examples of Selected Controls*
Investment assets are protected from loss or misappropriation. (Chapter 7)	• Responsibility for investment decisions and transactions is segregated from custodian's functions. • Financial stability of financial institutions holding investments is reviewed. • Securities that are physically held (e.g., by a custodian or depository) are periodically counted or otherwise verified. • Written-off investments are reviewed for possible appreciation. • Documents are controlled in a limited-access, fireproof area. • Securities held by independent custodians are confirmed. • Access to computerized investment records is limited to those with a logical need for such access. • The custodial function is separate from the responsibility for investment decisions, transactions, and recordkeeping.
Obligations under insurance companies' insurance contracts can be met. (Chapter 7)	• Financial statements of insurance companies are reviewed. • Rating bureau reports are reviewed.
For deposits with insurance companies, terms of insurance contracts are authorized. (Chapter 7)	• Terms are specified in the plan instrument. • Modifications of contracts are approved by the plan committee.

Contributions Received and Related Receivables and Participant Loans

Specific Objectives	*Examples of Selected Controls*
Amounts of contributions by employers and participants meet authorized or required amounts. (Chapter 8—*Auditing Contributions Received and Related Receivables*)	• Contribution requirements or limitations are described in the plan instrument or collective bargaining agreement. • Contributions are determined using approved eligibility lists. • Actuary is used to make periodic valuations and reports.
Contributions are recorded at the appropriate amount and in the appropriate period on a timely basis. (Chapter 8)	• Sponsor or employer payroll records are compared with contribution calculations. In the case of multiemployer plans, some form of periodic payroll audit is performed. • Initial controls are established over contribution records for both employer and participant contributions (e.g., salary reduction amounts, after tax and rollovers). • Clerical accuracy of contribution forms is checked. • Subsidiary contribution records are reconciled to the trustee/asset custodian or third party administrator reports. • Contribution forms are reconciled to cash receipts ledger and bank deposits. • Control totals for participant and employer contributions are maintained. • Contribution receipts are issued to participants containing notices requesting reviews of discrepancies. • Participant contributions are remitted to the trust within guidelines prescribed by Department of Labor regulation.

Contributions Received and Related Receivables and Participant Loans *(cont'd)*

Specific Objectives	*Examples of Selected Controls*
Loans receivable from plan participants and related interest income are properly reported. (Chapter 7)	• Loans are made only with proper authorization based on guidelines established in the plan instrument in conformance with ERISA and tax requirements. • Entries to detailed loan records are reconciled with cash disbursements and receipts records. • Interest income is calculated periodically in accordance with rates established in the plan instrument and properly accrued. • Detailed records maintained by third party administrator are reconciled with trustee's/asset custodian's reports. • Records are reviewed periodically for past-due amounts.
Access to cash receipts, cash receipts records, and contribution records is suitably controlled to prevent or detect within a timely period the interception of unrecorded cash receipts or the abstraction of recorded cash receipts. (Chapter 8)	• Cash is independently controlled upon receipt. • Cash receipts are deposited intact daily. • Checks are restrictively endorsed upon receipt. • Responsibility for receiving and processing contributions is adequately segregated. • Bank accounts are reconciled monthly. • Past-due contributions are investigated on a timely basis. • Access to computerized contribution records is limited to those with a logical need for such access.

Benefit Payments Claims and Distributions	
Specific Objectives	*Examples of Selected Controls*
Payments are recorded at the appropriate amount and in the appropriate period on a timely basis. (Chapter 9—*Auditing Benefit Payments*, and Chapter 10—*Auditing Participant Data and Plan Obligations)*	• Calculations supporting payments are checked for clerical accuracy. • Benefits and claims payable outstanding for a long period are investigated. • Initial controls are established over applications. • Amounts are compared with plan or insurance company records. • Control totals for monthly pension benefits are maintained. • Participants or beneficiaries are notified of their right to have denied claims reviewed. • Initial controls are established over the maximum contributions allowed under tax regulations and corrective distributions made as required by tax regulations. • Initial controls are established over hardship withdrawals and documentation is maintained that supports the withdrawal request, authorization, amount and adherence to related tax regulations. • If required by the plan agreement, participants making hardship withdrawals do not make any contributions to any plan during the 12 months following the withdrawal. • Initial controls are established over forfeitures and utilization/allocation of forfeitures is made in accordance with the plan agreement.

Benefit Payments Claims and Distributions *(cont'd)*

Specific Objectives	*Examples of Selected Controls*
Payments are determined and authorized in accordance with the plan instrument. (Chapters 9 and 10)	• Changes in participant eligibility are approved by the plan committee. • Eligibility lists are approved. • Signed application forms or other authorized procedures (i.e., endorsed checks) are used. • Applications that provide for review of eligibility, benefit amounts, or plan compliance require approval.
Participant's benefit and cash disbursement records are controlled to prevent or detect on a timely basis unauthorized or duplicate payments. (Chapters 9 and 10)	• Responsibilities for benefit approval, recording of benefits, and maintenance of participant files are adequately segregated. • Blank forms are prenumbered and effectively controlled. • Periodic correspondence with retired beneficiaries is maintained, and correspondence or payments are returnable to plan committee if undeliverable. • Check endorsements are compared with signature in applicable participant records. • Supporting documents are effectively canceled on payment. • Access to computerized benefit payment records is limited to those with a logical need for such access.

Participant Data (and Plan Obligations)

Specific Objectives	*Examples of Selected Controls*
Participant data are properly recorded on a timely basis. (Chapter 10—*Auditing Participant Data and Plan Obligations*)	• Participant forms (e.g., enrollment, transfers, investment allocation, etc.) are controlled and are maintained for future reference. • Participants are encouraged to review transactions initiated electronically or directly with the third party administrator. • The number of plan participants is reconciled using enrollment forms. • Subsidiary records are maintained for participants who are active, retired, or terminated with vested benefits. • Plan records maintained by the sponsor are reconciled with information maintained by third party service providers. • Participant data are updated and reconciled to employers' personnel and payroll records (or participating employers' in a multiemployer plan). • Account balances and benefit data are furnished to participants on written request.
Actuarial valuation of accumulated benefits or benefit obligations reflects the understanding and agreement of the plan committee or responsible officials. (Chapter 10)	• Plan committee or responsible officials discuss with the actuary the actuarial methods and significant assumptions that are the basis for actuarial calculations.
Accumulated benefit or benefit obligation amounts and other actuarially determined information are determined periodically and recorded in the plan's records at the appropriate amounts. (Chapter 10)	• Valuation report prepared by an enrolled actuary is reviewed. • Participant data in the actuary's valuation report are reconciled with the participants' subsidiary records. • Incurred but not reported claims are compared to historical claims lag reports on a periodic basis.

Participant Data (and Plan Obligations) *(cont'd)*

Specific Objectives	*Examples of Selected Controls*
Participant eligibility is determined in accordance with authorization. (Chapter 10)	• Eligibility is defined in the plan instrument. • Enrollment applications or third party enrollment reports are reviewed by the plan committee or a responsible official.
Employees are notified of their eligibility. (Chapter 10)	• Procedures for identifying and contacting eligible employees are established. • Employee participation refusals are retained for future reference.
Access to participants' data is controlled to prevent unauthorized changes or additions. (Chapter 10)	• Maintenance of participant data is segregated from responsibility for benefit approval or processing. • In the case of multiemployer plans, participant data on a sample basis are updated and reconciled to the contributing employer's personnel and payroll records during the course of a payroll audit. • All participant-initiated enrollments, transfers, changes in investment allocations, and other change requests must be authorized by the participant by submitting a manually signed request form. The ability to perform these activities electronically or directly with a third party administrator is restricted to authorized participants through the use of specific identification and a personnel identification number. Invalid attempts to access and perform functions are reviewed and investigated. • Written confirmation are sent to participants for participant-initiated account activity.

Administrative Expenses

Specific Objectives	*Examples of Selected Controls*
Administrative expenses are recorded at the appropriate amount and in the appropriate period on a timely basis. (Chapter 12—*Other Auditing Considerations*)	• Expenses are compared to contracts and to disbursements. • If expenses are allocated to more than one plan, investment or fund, allocation methods and calculations are reviewed.
Types of administrative services to be offered are authorized. (Chapter 12)	• Administrative services are described in the plan instrument. • Expenses are approved by a responsible official.
Access to accounts payable and cash disbursements records is controlled to prevent or detect on a timely basis unauthorized or duplicate payments. (Chapters 9 and 12)	• Responsibilities for expense approval and processing are adequately segregated. • Supporting documents are effectively canceled on payment.

Reporting

Specific Objectives	*Examples of Selected Controls*
Records are maintained in sufficient detail to provide for proper and timely reconciliation. (Chapter 1—*Introduction and Background*)	• For defined benefit plans, subsidiary ledgers are reconciled with the trustee's/asset custodian's reports on a periodic and timely basis. • For defined contribution plans the total of all participant account balances is reconciled to the net assets in the trustee's/asset custodian's reports on a periodic and timely basis.
Financial statements, actuarial information, disclosures and supplemental schedules as prepared are complete, accurate and in conformity with management's authorization. (Chapters 1 through 6, 10, and Appendix A)	• Procedures are established to identify required disclosure items, for example, party in interest transactions and transactions in excess of 5 percent of plan assets. • Accumulating information for disclosure in accordance with the rules and regulations of appropriate authorities. • Review of all financial reports and filings. • Written representations on financial matters are obtained from actuaries, trustees, asset custodians, insurance companies, and others. • Plan committee reviews presentation of, and disclosures in, financial reports. • Procedures are established to identify required supplemental schedules and determine that they are presented in accordance with the rules and regulations of appropriate authorities.
Journal entries made are authorized. (Chapters 1, 5, and 6)	• Journal entries are adequately approved by a responsible official.

Specific Objectives	*Examples of Selected Controls*
Accounting policies, including selections from among alternative principles, are adopted as authorized. (Chapters 1, 5, and 6)	• Responsibility is assigned for approval of accounting policies.
Direct and indirect access to the plan's records is controlled to protect against physical hazards and to prevent or detect on a timely basis unauthorized entries. (Chapters 1, 5, and 6)	• Critical forms are prenumbered and controlled before and after issuance. • Record files are maintained in a controlled area with a suitable retention program. • Information pertinent to plan activities is identified and prepared for analysis.

General Computer Controls (In-house system or service organization)

Specific Objectives	*Examples of Selected Controls*
Changes to application system programs are authorized, tested, reviewed and approved prior to implementation in the production environment, and system modifications are properly documented.	• Segregation of duties between end users, programmers, quality assurance, library management and production operations and support personnel is maintained throughout the program change management and development process. • Separate computer environments for application development and maintenance, quality assurance testing, and production processing are maintained. Programmers and quality assurance personnel are restricted from directly modifying production source and executable code. • Program code is moved to the production processing environment by library management personnel after approval by quality assurance and management personnel.
Development, implementation, and maintenance of information systems follow a defined systems development life cycle methodology which contains management's philosophy, guidelines and direction in developing, acquiring and maintaining application systems.	• A system development life cycle methodology exists and is followed.
Physical access to the computer facility containing hardware, peripherals, communications equipment, backup media and sensitive output and forms is restricted to authorized personnel.	• Formal procedures for granting and terminating access to company facilities, including computer center, exist and are followed. • Physical access to blank check stocks, printers, and signature fonts is restricted to authorized personnel. Check logs are used to confirm checks printed and numbers used.

Specific Objectives	*Examples of Selected Controls*
Logical access security is administered and maintained according to management's intentions and authorization.	• Access to the system is granted to individuals by security administration personnel based on written request for such authorization. • Access rights to terminated or transferred employees are removed or modified timely by the security administration personnel based upon written request from authorized management.
Access to computer resources such as application programs, data files, sensitive utilities and system commands is limited to authorized individuals.	• Access to the system is granted to each user via a unique user identification and password. • Access to systems is limited based upon job responsibilities. • The ability to modify application executable programs and production data files is limited to authorized individuals.
Remote access to dial-up system is established for authorized individuals, plan administrators and participants.	• The voice response system and inter/intra net access is limited to authorized participants through the use of specific identification and a personnel identification number. Invalid attempts to access and perform functions are rejected and transferred to an assigned representative.
Critical processing activities can be continued or restored to an acceptable level without prolonged delay or loss of service in the event of disruption.	• Master files and transaction files are stored off-site to allow recreation of the master file. • Contingency plans have been developed for alternative processing. • Disaster recovery plans have been developed and tested for adequacy.

Exhibit B-2

Examples of User Controls When a Service Organization is Utilized

Specific Objectives	*Examples of User Controls*
Investments Controls should provide reasonable assurance that the appropriate asset purchases or redemptions are made as a result of contributions, disbursements, or other changes	• Quarterly and annual plan reports are sent to the participant. Reports should be reviewed by the participant for accuracy of dividends and capital gains processing. Plan administrators should have procedures in place to timely follow-up on all reconciling items.
Contributions Received and Related Receivables and Participant Loans Controls should provide reasonable assurance that contributions are adequately safeguarded upon receipt and processed in a timely manner by authorized individuals.	• Confirmation notices (i.e., turnaround documents) and quarterly statements are mailed to plan administrators and participants. These individuals have procedures in place for reviewing these documents on a timely basis for accuracy and completeness. Plan administrators should have procedures in place to timely follow-up on all reconciling items. • Plan administrators should have policies and procedures in place, which provide reasonable assurance that the confidentiality of their password is maintained and access to the recordkeeping software is limited to authorized personnel.
Controls should provide reasonable assurance that contribution remittances are applied to the appropriate Plan and participant accounts and processed accurately and completely by money type (i.e., contributions versus loan repayments) according to the investment options selected by the participant.	• Confirmation notices (i.e., turnaround documents) and quarterly statements are mailed to plan administrators and participants. These individuals should have procedures in place for reviewing these documents on a timely basis for accuracy and completeness. • Plan administrators should have policies and procedures in place, which provide reasonable assurance that their input into the recordkeeping system is accurate and complete. Plan administrators should have procedures in place to timely follow-up on all reconciling items.

Specific Objectives	*Examples of Selected Controls*
Benefit Payments, Claims and Distributions: Controls should provide reasonable assurance that disbursements and related transactions (e.g., redemptions, forfeitures) are authorized and valid	• The plan administrator should have procedures in place which provide reasonable assurance that disbursement requests are authorized and in compliance with the plan provisions. • The plan administrator informs the recordkeeper in writing if any disbursement amounts are to be forfeited. The plan administrator should have procedures in place, which provide reasonable assurance the information communicated to the recordkeeper is complete and accurate.
Controls should provide reasonable assurance that disbursements and related transactions, including taxes, penalties and forfeitures, are recorded and processed accurately, completely and on a timely basis.	• The plan administrator informs the recordkeeper in writing if any disbursement amounts are to be forfeited. The plan administrator should have procedures in place, which provide reasonable assurance the information communicated to the recordkeeper is complete and accurate. • Confirmations and quarterly statements are sent to participants and plan administrators. Participants and plan administrators should have procedures in place for reviewing confirmations and quarterly statements on a timely basis for accuracy and completeness. Plan administrators should have procedures in place to timely follow-up on all reconciling items.

Examples of User Controls When a Service Organization is Utilized—continued

Specific Objectives	*Examples of User Controls*
Participant Data (and Plan Obligations) Controls should provide reasonable assurance that all additions and modifications to plan information are authorized and are recorded and processed completely, accurately and on a timely basis.	• Confirmation notices are sent to participants to confirm accuracy of additions and modifications of data. Plan administrators should have procedures in place to timely follow-up on all discrepancies. • Confirmations are reviewed by the participant.
Controls should provide reasonable assurance that participant data is recorded and processed accurately, completely and on a timely basis, and that modifications to participant data are valid and authorized.	• Confirmation notices are generated and mailed to participants to review the completeness and accuracy of information entered into the recordkeeping system. Plan administrators should have procedures in place to timely follow-up on all discrepancies. • Participants have procedures in place for regularly reviewing the completeness and accuracy of information included on the confirmation notices and communicating any discrepancies to the plan administrator or recordkeeper on a timely basis. • Plan administrators should have control policies and procedures in place which provide reasonable assurance that employees are eligible, authorized and valid participants before submitting employee application forms to the recordkeeper or enrolling employees through online access.
Controls should provide reasonable assurance that participants initiated transfers, changes in investment allocations, and other changes are authorized and valid.	• Confirmations and quarterly statements are sent to participants and plan administrators. Participants and plan administrators should have procedures in place for reviewing confirmations and quarterly statements on a timely basis for accuracy and completeness. Plan administrators should have procedures in place to timely follow-up on all reconciling items.

Specific Objectives	*Examples of Selected Controls*
Controls should provide reasonable assurance that participant-initiated transfers, changes in investment allocations, and other changes are processed accurately, completely and on a timely basis.	• Confirmations and quarterly statements are sent to participants and plan administrators. Participants and plan administrators should have procedures in place for reviewing confirmations and quarterly statements on a timely basis for accuracy and completeness. Plan administrators should have procedures in place to timely follow-up on all reconciling items.
Reporting:	
Controls should provide reasonable assurance that the annual plan reports are complete, accurate and generated on a timely basis.	• Quarterly statements and annual plan reports are sent to plan administrators. Plan administrators should have procedures in place for reviewing these documents on a timely basis for accuracy and completeness.
Controls should provide reasonable assurance that all plan amendments are implemented accurately and on a timely basis.	• Plan administrators should have procedures in place, which provide reasonable assurance that plan amendments are communicated accurately and on a timely basis to the recordkeeper.
Controls should provide reasonable assurance that accurate plan data is available to provide accurate results when annual testing is performed.	• Plan administrators should have procedures in place, which provide reasonable assurance that plan data (census and compensation) are communicated accurately and on a timely basis to the recordkeeper.
Controls should provide reasonable assurance that access to computer resources such as application programs, data files, sensitive utilities and system commands is limited to authorized individuals.	• Plan administrators should have policies and procedures in place, which provide reasonable assurance that the confidentiality of their password is maintained and access to the software is limited to authorized personnel.
Controls should provide reasonable assurance that remote access to recordkeeping systems are established for authorized individuals and customers.	• Policies and procedures should be designed and implemented at user organizations to provide reasonable assurance that access to the recordkeeping system's hardware, software, voice response system and password is granted only to authorized individuals.

Appendix C

Excerpt From FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans

This appendix reproduces the standards of financial accounting and reporting by defined benefit pension plans from paragraphs 1 through 30 of FASB Statement No. 35, as amended. FASB Statement No. 35 has been affected as follows:

- Paragraph 2 amended by FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*.
- Paragraph 11 amended by FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*.
- Paragraph 12 superseded by FASB Statement No. 110.
- Paragraph 30 amended by FASB Statement No. 59 and 75.
- Footnote 6 superseded by FASB Statement No. 110.

These standards are presented for the convenience of readers of this audit guide. A thorough understanding of these standards requires a reading of the entire statement, including its appendix B, "Basis for Conclusions," and its appendix D, "Illustration of Financial Statements." (The latter is reproduced, with revisions, in appendix D of this guide.) The complete statement is available from the Financial Accounting Standards Board.

Statement of Financial Accounting Standards No. 35[†]

Accounting and Reporting by Defined Benefit Pension Plans

March 1980

INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for the annual financial statements of a **defined benefit pension plan** (pension plan or plan).* Plans covered are those that principally provide **pension benefits** but may also provide **benefits** on death, disability, or termination of employment.

2. This Statement applies to an ongoing plan that provides pension benefits for the **employees** of one or more employers, including **state and local governments**,** or for the members of a trade or other employee association. Such a plan may have no intermediary **funding agency** or it may be financed through one or more trust funds, one or more contracts with insurance companies, or a combination thereof. This Statement applies to plans that are subject to the provisions of the Employee Retirement Income Security Act of 1974 (**ERISA** or the **Act**) as well as to those that are not. It is not intended to apply to a plan that is expected to be terminated, nor to a government-sponsored social security plan. This Statement does not require the preparation, distribution, or attestation of any plan's financial statements (paragraph 51).

3. Standards of financial accounting and reporting for defined benefit pension plans are presented in paragraphs 4-30. Background information for this Statement is presented in appendix A. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in appendix B. Illustrations of certain applications of the requirements of this Statement appear in Appendixes E and F.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Existing Generally Accepted Accounting Principles

4. Existing generally accepted accounting principles other than those discussed in this Statement may apply to the financial statements of defined benefit pension plans. The financial accounting standards discussed in this Statement are those of particular importance to pension plans or that differ from existing generally accepted accounting principles for other types of entities.

Primary Objective of Plan Financial Statements

5. The primary objective of a pension plan's financial statements is to provide financial information that is useful in assessing the plan's present and future

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* Terms defined in the Glossary (appendix D) are in boldface type the first time they appear in this Statement.

** This shading technique is used to alert the reader when paragraphs containing accounting standards have been amended or superseded. All terms and sentences that have been deleted or replaced are shaded. Paragraphs and subparagraphs that have been amended simply by the addition of terms, sentences, or new footnotes are marked with a vertical solid bar in the left margin alongside the paragraph or subparagraph.

ability to pay benefits when due.[1] To accomplish that objective, a plan's financial statements should provide information about (a) plan resources and how the stewardship responsibility for those resources has been discharged, (b) the **accumulated plan benefits** of **participants,** (c) the results of transactions and events that affect the information regarding those resources and benefits, and (d) other factors necessary for users to understand the information provided.

Financial Statements

6. The annual financial statements of a plan shall include:

a. A statement that includes information regarding the **net assets available for benefits** as of the end of the plan year

b. A statement that includes information regarding the changes during the year in the net assets available for benefits

c. Information regarding the **actuarial present value of accumulated plan benefits** as of either the beginning[2] or end of the plan year

d. Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the actuarial present value of accumulated plan benefits.

7. The primary objective set forth in paragraph 5 is satisfied only if (a) information regarding both the net assets available for benefits and the actuarial present value of accumulated plan benefits is presented as of the same date and (b) information regarding both the changes in net assets available for benefits and the changes in the actuarial present value of accumulated plan benefits is presented for the same period. Therefore, if the **benefit information date** pursuant to paragraph 6(c) is the beginning of the year, a statement that includes information regarding the net assets available for benefits as of that date and a statement that includes information regarding the changes during the preceding year in the net assets available for benefits shall also be presented. Use of an end-of-year benefit information date is considered preferable. Plans are encouraged to develop procedures to enable them to use that date (paragraph 29).

8. The Board believes it is desirable to allow certain flexibility in presenting the information regarding the actuarial present value of accumulated plan benefits and the year-to-year changes therein. Therefore, either or both of those categories of information may be presented on the face of one or more financial statements or in notes thereto. Regardless of the format selected, each category of information shall be presented in its entirety in the same location. If a statement format is selected for either category, a separate statement may be used to present that information or, provided the information is as of the same date or for the same period, that information may be presented together with information regarding the net assets available for benefits and the year-to-year changes therein.

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[1] The Board recognizes that (a) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (b) financial statements for several plan years can provide information more useful in assessing the plan's future ability to pay benefits than can the financial statements for a single plan year (paragraphs 58-63).

[2] Financial information presented as of the beginning of the year shall be the amounts as of the end of the preceding year.

Net Assets Available for Benefits

9. The accrual basis of accounting[3] shall be used in preparing information regarding the net assets available for benefits. The information shall be presented in such reasonable detail as is necessary to identify the plan's resources that are available for benefits.

Contributions Receivable

10. Contributions receivable are the amounts due as of the **reporting date** to the plan from the employer(s), participants, and other sources of funding (for example, state subsidies or federal grants—which shall be separately identified). Amounts due include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (a) a resolution by the employer's governing body approving a specified contribution, (b) a consistent pattern of making payments after the plan's year-end pursuant to an established **funding policy** that attributes such subsequent payments to the preceding plan year, (c) a deduction of a contribution for federal tax purposes for periods ending on or before the reporting date, or (d) the employer's recognition as of the reporting date of a contribution payable to the plan.[4]

Investments

11. Plan investments, whether equity or debt securities, real estate, or other (excluding contracts with insurance companies) shall be presented at their fair value at the reporting date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is not an active market for an investment but there is such a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[5]

12. Contracts with insurance companies shall be presented in the same manner as that contained in the annual report filed by the plan with certain governmental agencies pursuant to ERISA.[6] A plan not subject to ERISA shall similarly present its contracts with insurance companies, that is, as if the plan were subject to the reporting requirements of ERISA.

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[3] The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is after the reporting date and (a) the fair value of securities purchased or sold just before the reporting date does not change significantly from the trade date to the reporting date, and (b) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[4] The existence of accrued pension costs does not, by itself, provide sufficient support for recognition of a contribution receivable (paragraph 92).

[5] For an indication of factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment shall reflect the brokerage commissions and other costs normally incurred in a sale.

[6] For 1979 plan years, the pertinent governmental reporting requirements relate to item 13 of either Form 5500 or Form 5500-C.

13. Information regarding a plan's investments shall be presented in enough detail to identify the types of investments and shall indicate whether reported fair values have been measured by quoted prices in an active market or are fair values otherwise determined. (Paragraphs 28(g) and 28(h) require certain additional disclosures related to investments.)

Operating Assets

14. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be presented at cost less accumulated depreciation or amortization.

Changes in Net Assets Available for Benefits

15. Information regarding changes in net assets available for benefits shall be presented in enough detail to identify the significant changes during the year. Minimum disclosure shall include:

a. The net appreciation (depreciation)[7] in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined

b. Investment income (exclusive of (a) above)

c. Contributions from the employer(s), segregated between cash and noncash contributions[8]

d. Contributions from participants, including those transmitted by the **sponsor**

e. Contributions from other identified sources (for example, state subsidies or federal grants)

f. Benefits paid to participants

g. Payments to insurance companies to purchase contracts that are excluded from plan assets[9]

h. Administrative expenses.

Actuarial Present Value of Accumulated Plan Benefits

16. Accumulated plan benefits are those future benefit payments that are attributable under the plan's provisions to employees' **service** rendered to the benefit information date. Accumulated plan benefits comprise benefits expected to be paid to (a) retired or terminated employees or their beneficiaries, (b) beneficiaries of deceased employees, and (c) present employees or their beneficiaries.

17. To the extent possible, plan provisions shall apply in measuring accumulated plan benefits. In some plans, benefits are a specified amount for each year of service. Even if a plan does not specify a benefit for each year of service, another of its provisions (for example, a provision applicable to terminated employees or to termination of the plan—if independent of funding patterns) may indicate how to measure accumulated plan benefits. If the benefit for each

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[7] Realized gains and losses on investments that were both bought and sold during the year shall be included.

[8] A noncash contribution shall be recorded at fair value. The nature of noncash contributions shall be described, either parenthetically or in a note.

[9] Paragraph 28(e) requires disclosure of the plan's dividend income related to excluded contracts and permits that income to be netted against item (g).

year of service is not stated by or clearly determinable from the provisions of the plan, the benefit shall be considered to accumulate in proportion to (a) the ratio of the number of years of service completed to the benefit information date to the number that will have been completed when the benefit will first be fully vested, if the type of benefit is includable in **vested benefits** (for example, a supplemental early retirement benefit that is a vested benefit after a stated number of years of service), or (b) the ratio of completed years of service to projected years of service upon anticipated separation from covered employment, if the type of benefit is not includable in vested benefits (for example, a death or disability benefit that is payable only if death or disability occurs during active service).

18. In measuring accumulated plan benefits, the following shall apply:

a. Except as indicated in (b) and (c) below, accumulated plan benefits shall be based on employees' history of pay and service and other appropriate factors as of the benefit information date.[10]

b. Projected years of service shall be a factor only in determining employees' expected eligibility for particular benefits, such as:

i. Increased benefits that are granted provided a specified number of years of service are rendered (for example, a pension benefit that is increased from $9 per month to $10 per month for each year of service if 20 or more years of service are rendered)

ii. Early retirement benefits

iii. Death benefits

iv. Disability benefits.

c. Automatic benefit increases specified by the plan (for example, automatic cost-of-living increases) that are expected to occur after the benefit information date shall be recognized.

d. Benefits to be provided by means of contracts excluded from plan assets for which payments to the insurance company have been made shall be excluded.

e. Plan amendments adopted after the benefit information date shall not be recognized.

f. If it is necessary to take future compensation into account in the determination of Social Security benefits, employees' compensation as of the benefit information date shall be assumed to remain unchanged during their assumed future service. Increases in the wage base or benefit level pursuant to either the existing Social Security law or possible future amendments of the law shall not be recognized.

19. The actuarial present value of accumulated plan benefits is that amount as of the benefit information date that results from applying actuarial assumptions to the benefit amounts determined pursuant to paragraphs 16-18, with the actuarial assumptions being used to adjust those amounts to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the benefit information date and the expected date of payment.

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[10] An example of the application of paragraphs 18(a) and 18(b) appears in Appendix E.

20. An assumption of an ongoing plan shall underlie the other assumptions used in determining the actuarial present value of accumulated plan benefits. Every other significant assumption used in that determination and disclosed pursuant to paragraph 27(b) shall reflect the best estimate of the plan's future experience solely with respect to that individual assumption. As to certain assumptions, the following shall apply:

a. Assumed rates of return shall reflect the expected rates of return during the periods for which payment of benefits is deferred and shall be consistent with returns realistically achievable on the types of assets held by the plan and the plan's investment policy. To the extent that assumed rates of return are based on values of existing plan assets, the values used in determining assumed rates of return shall be the values presented in the plan's financial statements pursuant to the requirements of this Statement.

b. Expected rates of inflation assumed in estimating automatic cost-of-living adjustments shall be consistent with the assumed rates of return.

c. Administrative expenses expected to be paid by the plan (not those paid by the sponsor) that are associated with providing accumulated plan benefits shall be reflected either by appropriately adjusting the assumed rates of return or by assigning those expenses to future periods and discounting them to the benefit information date. If the former method is used, the adjustment of the assumed rates of return shall be separately disclosed (paragraph 27(b)).

21. In selecting certain assumptions to be used in determining the actuarial present value of accumulated plan benefits, an acceptable alternative to that discussed in paragraph 20 is to use those assumptions that are inherent in the estimated cost at the benefit information date to obtain a contract with an insurance company to provide participants with their accumulated plan benefits. Those other assumptions that are necessary but are not inherent in that estimated cost shall be selected pursuant to the requirements in paragraph 20.

Presentation of the Actuarial Present Value of Accumulated Plan Benefits

22. The total actuarial present value of accumulated plan benefits as of the benefit information date shall be segmented into at least the following categories:

a. Vested benefits of participants currently receiving payments

b. Other vested benefits

c. Nonvested benefits.

Category (a) shall include those benefits due and payable as of the benefit information date. Present employees' accumulated contributions as of the benefit information date (including interest, if any) shall be disclosed. If interest has been credited on employees' contributions, the rate(s) shall be disclosed.

Changes in the Actuarial Present Value of Accumulated Plan Benefits

23. Changes in actuarial assumptions made to reflect changes in the plan's expected experience shall be viewed as changes in estimates. That is, the effects of those changes shall be accounted for in the year of change (or in the year of change and future years if the change affects both) and shall not be accounted for by restating amounts reported in financial statements for prior years or by reporting pro forma amounts for prior years.

24. Assumed rates of return used to determine the actuarial present value of accumulated plan benefits may change periodically due to changes in expected rates of return or as changes occur in the factors affecting estimates. A change in assumed rates of return need not necessarily result when a decision is made to replace fixed-income securities currently held with lower-rated fixed-income securities because the higher yield associated with the lower-rated securities reflects increased risk. Accordingly, a higher ultimate return on the aggregate investment portfolio may not result.

Presentation of Changes in the Actuarial Present Value of Accumulated Plan Benefits

25. If significant, either individually or in the aggregate, the effects of certain factors affecting the change in the actuarial present value of accumulated plan benefits from the preceding to the current benefit information date shall be identified. Effects that are individually significant shall be separately identified. Minimum disclosure shall include the significant effects of factors such as the following:

a. Plan amendments

b. Changes in the nature of the plan (for example, a plan spin-off or a merger with another plan)

c. Changes in actuarial assumptions.[11]

The significant effects of other factors may also be identified, including, for example, benefits accumulated,[12] the increase (for interest) as a result of the decrease in the discount period, and benefits paid. If presented, *benefits paid* shall not include benefit payments made by an insurance company in accordance with a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchasing annuities with amounts allocated from existing investments with the insurance company) shall be included in *benefits paid.*[13] If the minimum required disclosure is presented in other than a statement format, the actuarial present value of accumulated plan benefits as of the preceding benefit information date shall also be presented.

26. Information regarding changes in the actuarial present value of accumulated plan benefits may be presented either (a) in a statement that accounts for the change between two benefit information dates or (b) elsewhere in the fin-

[11] Plans that measure the actuarial present value of accumulated plan benefits by insurance company rates pursuant to the alternative approach described in paragraph 21 shall, if practicable, disclose the effects of changes in actuarial assumptions reflected in changes in those insurance rates.

[12] Actuarial experience gains or losses may be included with the effects if additional benefits accumulated rather than being separately disclosed. If the effects of changes in actuarial assumptions discussed in footnote 11 cannot be separately disclosed, those effects shall be included in benefits accumulated.

[13] Due to the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumulated plan benefits. That difference is an actuarial experience gain or loss (footnote 12).

ancial statements. If only the minimum required disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the beginning and ending amounts.

Additional Financial Statement Disclosures

27. Disclosure of the plan's accounting policies[14] shall include the following:

a. A description of the method(s) and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies.

b. A description of the method and significant assumptions (for example, assumed rates of return, inflation rates, and retirement ages) used to determine the actuarial present value of accumulated plan benefits. Any significant changes of method or assumptions between benefit information dates shall be described.

28. The financial statements shall include the following additional disclosures, if applicable:

a. A brief, general description of the plan agreement, including—but not limited to—vesting and benefit provisions.[15]

b. A description of significant plan amendments adopted during the year ending on the latest benefit information date. If significant amendments were adopted between the latest benefit information date and the plan's year-end, it shall be indicated that the actuarial present value of accumulated plan benefits does not reflect those amendments.

c. A brief, general description of (i) the priority order of participants' claims to the assets of the plan upon plan termination and (ii) benefits guaranteed by the Pension Benefit Guaranty Corporation (**PBGC**), including a discussion of the application of the PBGC guaranty to any recent plan amendment.[16]

d. The funding policy and any changes in such policy during the plan year.[17] For a **contributory plan,** the disclosure shall state the method of determining participants' contributions. Plans subject to ERISA shall disclose whether the minimum funding requirements of ERISA have been met. If a minimum funding waiver has been granted by the Internal Revenue Service (*IRS*) or if a request for a waiver is pending before the IRS, that fact shall be disclosed.

e. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. The plan's dividend income for the year that is related to excluded contracts shall be disclosed, and for purposes of paragraph 15 may be netted against item (g).

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[14] See APB Opinion No. 22, *Disclosure of Accounting Policies.*

[15] If a plan agreement or a description thereof providing this information is otherwise published and made available, the description required by paragraph 28(a) may be omitted provided that reference to such other source is made.

[16] If material providing this information is otherwise published and made available to participants, the descriptions required by paragraph 28(c) may be omitted provided that (a) reference to such other source is made and (b) disclosure similar to the following is made in the financial statements: "Should the plan terminate at some future time, its net assets generally will not be available on a pro rata basis to provide participants' benefits. Whether a particular participant's accumulated plan benefits will be paid depends on both the priority of those benefits and the level of benefits guaranteed by the PBGC at that time. Some benefits may be fully or partially provided for by the then existing assets and the PBGC guaranty while other benefits may not be provided for at all."

[17] If significant costs of plan administration are being absorbed by the employer(s), that fact shall be disclosed.

f. The federal income tax status of the plan, if a favorable letter of determination has not been obtained or maintained.

g. Identification of investments that represent five percent or more of the net assets available for benefits.

h. Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: (i) the sponsor, (ii) the employer(s), or (iii) the employee organization(s).

i. Unusual or infrequent events or transactions occurring after the latest benefit information date but before issuance of the financial statements that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest benefit information date that significantly increases future benefits that are attributable to employees' service rendered before that date shall be disclosed. If reasonably determinable, the effects of such events or transactions shall be disclosed. If such effects are not quantified, the reasons why they are not reasonably determinable shall be disclosed.

Use of Averages or Reasonable Approximations

29. The Board recognizes that literal application of certain of the requirements of this Statement could require a degree of detail in recordkeeping and computation that might be unduly burdensome. Accordingly, the use of averages or other methods of approximation is appropriate, provided the results obtained are substantially the same as the results contemplated by this Statement. Thus, rolling back to the beginning of the year or projecting to the end of the year detailed employee service-related data as of a date within the year may be acceptable in approximating beginning-or end-of-year **benefit information.** The use of averages and other methods of approximation consistent with recommended actuarial practice may be useful in conjunction with other provisions of this Statement, particularly when applied to plans sponsored by small employers. If participants' individual historical salary data for plan years before the effective date of this Statement are not available, reasonable approximations thereof are acceptable.

Effective Date and Transition

30. This Statement shall be effective for plan years beginning after December 15, 1980. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be made retroactively. Financial statements of prior plan years are required to be restated to comply with the provisions of this Statement *only* if presented together with financial statements for plan years beginning after December 15, 1980. If accounting changes were necessary to conform to the provisions of this Statement, that fact shall be disclosed when financial statements for the year in which this Statement is first applied are presented either alone or only with financial statements of prior years.

The provisions of this Statement need not be applied to immaterial items.

Appendix D*

Illustration of Financial Statements: Defined Benefit Pension Plan

This appendix illustrates certain applications of the requirements of FASB Statement No. 35 (the "Statement"), as amended, that are applicable for the annual financial statements of a hypothetical plan, the C&H Company Pension Plan. It does not illustrate other requirements of the Statement, as amended, that might be applicable in circumstances other than those assumed for the C&H Company Pension Plan. The formats presented and the wording of accompanying notes are illustrative and are not necessarily the only possible presentation. Further, the circumstances assumed for the C&H Company Pension Plan are designed to facilitate illustration of many of the requirements of the Statement, as amended. Therefore, the notes to the illustrative financial statements probably are more extensive than would be expected for a typical plan.

Included are illustrations of the following alternatives permitted by paragraphs 6, 8, 25, and 26:

a. An end-of-year vs. beginning-of-year benefit information date.

b. Separate vs. combined statements for presenting information regarding (a) the net assets available for benefits and the actuarial present value of accumulated plan benefits and (b) changes in the net assets available for benefits and changes in the actuarial present value of accumulated plan benefits.

c. A separate statement that reconciles the year-to-year change in the actuarial present value of accumulated plan benefits vs. presenting the effects of a change in actuarial assumptions on the face of the statement of accumulated plan benefits.

Although not illustrated, paragraph 8 of the Statement permits the information regarding the actuarial present value of accumulated plan benefits and changes therein to be presented as notes to the financial statements.

This appendix also illustrates certain applications of the provisions of SOP 99-2 that apply for the annual financial statements of a hypothetical defined benefit pension plan that has been amended to include a 401(h) account (Exhibits D-9 through D-11). It does not illustrate other provisions of the SOP that might apply in circumstances other than those assumed in the illustration. It also does not illustrate all disclosures required for a fair presentation in conformity with GAAP. The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

The notes to the financial statements are for the illustrative financial statements that use end-of-year benefit information. Modifications to the notes necessary when beginning-of-year benefit information is presented are in brackets.

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* Source: FASB Statement No. 35, appendix D, modified for changes required by FASB Statement No. 110 and ERISA requirements.

Generally accepted accounting principles do not require comparative financial statements unless the beginning-of-year benefit information is used. In this case, a prior-year statement of net assets available for benefits and changes therein must also be presented in order to report on the financial status of the plan. ERISA requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

ERISA and DOL regulations require that certain information be included in supplemental schedules, which are not required under generally accepted accounting principles, and reported on by the independent auditor. See appendix A for a further discussion of the ERISA and DOL requirements.

CONTENTS

The Statement of Net Assets Available for Benefits assuming a beginning-of-year information date would be the same as that illustrated in Exhibit D-1.

Exhibit D-1

C&H COMPANY PENSION PLAN

STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS

	December 31,	
	20X1	20X0
Assets		
Investments, at fair value (Notes B, E, F, and G):		
Plan interest in C&H Master Trust	$2,250,000	$1,860,000
C&H Company common stock	690,000	880,000
Investment contract with Insurance company	1,000,000	890,000
Corporate bonds and debentures	3,500,000	3,670,000
U.S. government securities	350,000	270,000
Mortgages	480,000	460,000
Real estate	270,000	240,000
Total investments	8,540,000	8,270,000
Receivables:		
Employer's contribution	40,000	35,000
Securities sold	310,000	175,000
Accrued interest and dividends	77,000	76,000
Total receivables	427,000	286,000
Cash	200,000	90,000
Total assets	9,167,000	8,646,000
Liabilities		
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	85,000	40,000
Total liabilities	155,000	500,000
Net assets available for benefits	$9,012,000	$8,146,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-2

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

	Year Ended December 31, 20X1
Investment income:	
Net appreciation in fair value of investments (Note E)	$ 278,000
Interest	325,000
Dividends	5,000
	608,000
Less investment expenses	39,000
	569,000
Plan interest in C&H Master Trust investment income (Note F)	129,000
	698,000
Contributions (Note C):	
Employer	780,000
Employees	450,000
	1,230,000
Total additions	1,928,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	65,000
Total deductions	1,062,000
Net increase	866,000
Net assets available for benefits:	
Beginning of year	8,146,000
End of year	$9,012,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-3

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS

	December 31,	
	20X1	20X0
Actuarial present value of accumulated plan benefits (Notes B and C)		
Vested benefits:		
Participants currently receiving payments	$ 3,040,000	$ 2,950,000
Other participants	8,120,000	6,530,000
	11,160,000	9,480,000
Nonvested benefits	2,720,000	2,400,000
Total actuarial present value of accumulated plan benefits	$13,880,000	$11,880,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-4

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN ACCUMULATED PLAN BENEFITS

	Year Ended December 31, 20X1
Actuarial present value of accumulated plan benefits at beginning of year	$11,880,000
Increase (decrease) during the year attributable to:	
Plan amendment (Note H)	2,410,000
Change in actuarial assumptions (Note B)	(1,050,500)
Benefits accumulated	895,000
Increase for interest due to the decrease in the discount period (Note B)	742,500
Benefits paid	(997,000)
Net increase	2,000,000
Actuarial present value of accumulated plan benefits at end of year	$13,880,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-5

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS AND NET ASSETS AVAILABLE FOR BENEFITS

[An alternative for Exhibits D-1 and D-3]

	December 31, 20X1	December 31, 20X0
Accumulated Plan Benefits (Notes B and C)		
Actuarial present value of vested benefits		
Participants currently receiving payments	$3,040,000	$2,950,000
Other participants	8,120,000	6,530,000
	11,160,000	9,480,000
Actuarial present value of nonvested benefits	2,720,000	2,400,000
Total actuarial present value of accumulated plan benefits	13,880,000	11,880,000
Net Assets Available for Benefits		
Investments, at fair value (Notes B, E, F, and G):		
Plan interest in C&H Master Trust	2,250,000	1,860,000
C&H Company common stock	690,000	880,000
Investment contract with Insurance company	1,000,000	890,000
Corporate bonds and debentures	3,500,000	3,670,000
U.S government securities	350,000	270,000
Mortgages	480,000	460,000
Real estate	270,000	240,000
Total investments	8,540,000	8,270,000
Receivables:		
Employer's contribution	40,000	35,000
Securities sold	310,000	175,000
Accrued interest and dividends	77,000	76,000
Total receivables	427,000	286,000
Cash	200,000	90,000
Total assets	9,167,000	8,646,000
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	85,000	40,000
Total liabilities	155,000	500,000
Net assets available for benefits	9,012,000	8,146,000
Excess of actuarial present value of accumulated plan benefits over net assets available for benefits	$4,868,000	$3,734,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-6

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN ACCUMULATED PLAN BENEFITS AND NET ASSETS AVAILABLE FOR BENEFITS

[An alternative for Exhibits D-2 and D-4]

	Year Ended December 31, 20X1
Net Increase in Actuarial Present Value of Accumulated Plan Benefits	
Increase (decrease) during the year attributable to:	
Plan amendment (Note H)	$2,410,000
Change in actuarial assumptions (Note B)	(1,050,500)
Benefits accumulated	895,000
Increase for interest due to the decrease in the discount period (Note B)	742,500
Benefits paid	(997,000)
Net increase	2,000,000
Net Increase in Net Assets Available for Benefits	
Investment income:	
Net appreciation in fair value of investments (Note E)	278,000
Interest	325,000
Dividends	5,000
	608,000
Less investment expenses	39,000
	569,000
Plan interest in C&H Master Trust investment income (Note F)	129,000
	698,000
Contributions (Note C):	
Employer	780,000
Employees	450,000
	1,230,000
Total additions	1,928,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	65,000
Total deductions	1,062,000
Net increase	866,000
Increase in excess of actuarial present value of accumulated plan benefits over net assets available for benefits	1,134,000
Excess of actuarial present value of accumulated plan benfits over net assets available for benefits:	
Beginning of year	3,734,000
End of year	$4,868,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-7

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

(If a beginning-of-year benefit information date is selected)

	Year Ended December 31, 20X1	Year Ended December 31, 20X0
Investment income:		
Net appreciation in fair value of investments (Note E)	$ 278,000	$ 41,000
Interest	325,000	120,000
Dividends	5,000	90,000
	608,000	251,000
Less investment expenses	39,000	35,000
	569,000	216,000
Plan interest in C&H Master Trust investment income (Note F)	129,000	150,000
	698,000	366,000
Contributions (Note C):		
Employer	780,000	710,000
Employees	450,000	430,000
	1,230,000	1,140,000
Total additions	1,928,000	1,506,000
Benefits paid directly to participants	740,000	561,000
Purchases of annuity contracts (Note G)	257,000	185,000
	997,000	746,000
Administrative expenses	65,000	58,000
Total deductions	1,062,000	804,000
Net increase	866,000	702,000
Net assets available for benefits:		
Beginning of year	8,146,000	7,444,000
End of year	$9,012,000	$8,146,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-8

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS

(If a beginning-of-year benefit information date is selected)

	December 31, 20X0
Actuarial present value of accumulated plan benefits (Notes B and C)	
Vested benefits:	
Participants currently receiving payments	$ 2,950,000
Other participants	6,530,000
	9,480,000
Nonvested benefits	2,400,000
Total actuarial present value of accumulated plan benefits	$11,880,000

During 20X0, the actuarial present value of accumulated plan benefits increased $700,000 as a result of a change in actuarial assumptions (Note B). Also see Note H. The actuarial present value of accumulated plan benefits was $9,890,000 at December 31, 20W9.

The accompanying notes are an integral part of the financial statements.

C&H COMPANY PENSION PLAN

NOTES TO FINANCIAL STATEMENTS[104]

A. Description of Plan

The following brief description of the C&H Company Pension Plan (Plan) is provided for general information purposes only. Participants should refer to the Plan agreement for more complete information.

1. *General.* The Plan is a defined benefit pension plan covering substantially all employees of C&H Company (Company). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

2. *Pension Benefits.* Employees with 5 or more years of service are entitled to annual pension benefits beginning at normal retirement age (65) equal to 1 ½% of their final 5-year average annual compensation for each year of service. The Plan permits early retirement at ages 55-64. Employees may elect to receive their pension benefits in the form of a joint and survivor annuity. If employees terminate before rendering 5 years of service, they forfeit the right to receive the portion of their accumulated plan benefits attributable to the Company's contributions. Employees may elect to receive the value of their accumulated plan benefits as a lump-sum distribution upon retirement or termination, or they may elect to receive their benefits as a life annuity payable monthly from retirement. For each employee electing a life annuity, payments will not be less than the greater of (a) the employee's accumulated contributions plus interest or (b) an annuity for five years.

3. *Death and Disability Benefits.* If an active employee dies at age 55 or older, a death benefit equal to the value of the employee's accumulated pension benefits is paid to the employee's beneficiary. Active employees who become totally disabled receive annual disability benefits that are equal to the normal retirement benefits they have accumulated as of the time they become disabled. Disability benefits are paid until normal retirement age at which time disabled participants begin receiving normal retirement benefits computed as though they had been employed to normal retirement age with their annual compensation remaining the same as at the time they became disabled.

B. Summary of Accounting Policies

The following are the significant accounting policies followed by the Plan:

1. *Basis of Accounting.* The accompanying financial statements are prepared on the accrual basis of accounting.

2. *Use of Estimates.* The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that

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[104] The notes are for the accompanying illustrative financial statements that use an end-of-year benefit information date. Modifications necessary to accompany the illustrative financial statements that use a beginning-of-year benefit information date are presented in brackets.

affect the reported amounts of assets, liabilities and changes therein, disclosure of contingent assets and liabilities, and the actuarial present value of accumulated plan benefits at the date of the financial statements. Actual results could differ from those estimates.

3. *Investment Valuation and Income Recognition.* If available, quoted market prices are used to value investments.

   The amounts shown in Note E for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at that fair market value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices. Mortgages have been valued on the basis of their future principal and interest payments discounted at prevailing interest rates for similar investments. The fair value of real estate investments, principally rental property subject to long-term leases has been estimated on the basis of future rental receipts and estimated residual values discounted at interest rates commensurate with the risks involved. The fair value of the Plan's interest in the C&H Master Trust (Master Trust) is based on the beginning of year value of the Plan's interest in the trust plus actual contributions and allocated investment income less actual distributions and allocated administrative expenses (Note F). Quoted market prices are used to value investments in the Master Trust. The Plan's investment contract with the National Insurance Company (National) (Note G) is valued at fair value by discounting the related cash flows based on current yields of similar instruments with comparable durations. Funds under the investment contract that have been allocated and applied to purchase annuities (that is, National is obligated to pay the related pension benefits) are excluded from the Plan's assets.

   Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

4. *Actuarial Present Value of Accumulated Plan Benefits.* Accumulated plan benefits are those future periodic payments, including lump-sum distributions, that are attributable under the Plan's provisions to the service employees have rendered. Accumulated plan benefits include benefits expected to be paid to (a) retired or terminated employees or their beneficiaries, (b) beneficiaries of employees who have died, and (c) present employees or their beneficiaries. Benefits under the Plan are based on employees' compensation during their last five years of credited service. The accumulated plan benefits for active employees are based on their average compensation during the five years ending

on the date as of which the benefit information is presented (the valuation date). Benefits payable under all circumstances—retirement, death, disability, and termination of employment—are included, to the extent they are deemed attributable to employee service rendered to the valuation date. Benefits to be provided via annuity contracts excluded from Plan assets are excluded from accumulated Plan benefits.

The actuarial present value of accumulated plan benefits is determined by an actuary from the AAA Company and is that amount that results from applying actuarial assumptions to adjust the accumulated plan benefits to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment. The significant actuarial assumptions used in the valuations as of December 31, 20X1 [20X0] and 20X0 were (a) life expectancy of participants (the 1991 Group Annuity Mortality Table was used), (b) retirement age assumptions (the assumed average retirement age was 60), and (c) investment return. The 20X1 [20X0] and 20X0 valuations included assumed average rates of return of 7% [6.25%] and 6.25%, respectively, including a reduction of .2% to reflect anticipated administrative expenses associated with providing benefits. The foregoing actuarial assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of accumulated plan benefits.

5. *Payment of Benefits.* Benefit payments to participants are recorded upon distribution.

C. Funding Policy

As a condition of participation, employees are required to contribute 3% of their salary to the Plan. Present employees' accumulated contributions at December 31, 20X1 and 20X0 were $2,575,000 and $2,325,000, respectively, including interest credit on an interest rate of 5% compounded annually. The Company's funding policy is to make annual contributions to the Plan in amounts that are estimated to remain a constant percentage of employees' compensation each year (approximately 5% for 20X1 [and 20X0]), such that, when combined with employees' contributions, all employees' benefits will be fully provided for by the time they retire. Beginning in 20X2, the Company's contribution is expected to increase to approximately 6% to provide for the increase in benefits attributable to the Plan amendment effective July, 20X1 (Note H). The Company's contributions for 20X1 [and 20X0] exceeded the minimum funding requirements of ERISA.

Although it has not expressed any intention to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions set forth in ERISA.

D. Plan Termination

In the event the Plan terminates, the net assets of the Plan will be allocated, as prescribed by ERISA and its related regulations, generally to provide the following benefits in the order indicated:

a. Benefits attributable to employee contributions, taking into account those paid out before termination.

b. Annuity benefits that former employees or their beneficiaries have been receiving for at least three years, or that employees eligible to retire for that three-year period would have been receiving if they had retired with benefits in the normal form of annuity under the Plan. The priority amount is limited to the lowest benefit that was payable (or would have been payable) during those three years. The amount is further limited to the lowest benefit that would be payable under Plan provisions in effect at any time during the five years preceding Plan termination.

c. Other vested benefits insured by the Pension Benefit Guaranty Corporation (PBGC) (a U.S. government agency) up to the applicable limitations (discussed below).

d. All other vested benefits (that is, vested benefits not insured by the PBGC).

e. All nonvested benefits.

Benefits to be provided via contracts under which National (Note G) is obligated to pay the benefits would be excluded for allocation purposes.

Certain benefits under the Plan are insured by the PBGC if the Plan terminates. Generally, the PBGC guarantees most vested normal age retirement benefits, early retirement benefits, and certain disability and survivor's pensions. However, the PBGC does not guarantee all types of benefits under the Plan, and the amount of benefit protection is subject to certain limitations. Vested benefits under the Plan are guaranteed at the level in effect on the date of the Plan's termination. However, there is a statutory ceiling, which is adjusted periodically, on the amount of an individual's monthly benefit that the PBGC guarantees. For Plan terminations occurring during 20X2 that ceiling is $X,XXX per month. That ceiling applies to those pensioners who elect to receive their benefits in the form of a single-life annuity and are at least 65 years old at the time of retirement or plan termination (whichever comes later). For younger annuitants or for those who elect to receive their benefits in some form more valuable than a single-life annuity, the corresponding ceilings are actuarially adjusted downward. Benefit improvements attributable to the Plan amendment effective July 1, 20X1 (Note H) may not be fully guaranteed even though total benefit entitlements fall below the aforementioned ceilings. For example, none of the improvement would be guaranteed if the Plan were to terminate before July 1, 20X2. After that date, the PBGC would guarantee 20% of any benefit improvements that resulted in benefits below the ceiling, with an additional 20% guaranteed each year the Plan continued beyond July 1, 20X2. If the amount of the benefit increase below the ceiling is also less than $100, $20 of the increase (rather than 20%) becomes guaranteed by the PBGC each year following the effective date of the amendment. As a result, only the primary ceiling would be applicable after July 1, 20X6.

Whether all participants receive their benefits should the Plan terminate at some future time will depend on the sufficiency, at that time, of the Plan's net assets to provide for accumulated benefit obligations and may also depend on the financial condition of the Plan sponsor and the level of benefits guaranteed by the PBGC.

E. Investments

The following table presents the fair values of investments. Investments that represent 5 percent or more of the Plan's net assets are separately identified.

	December 31, 20X1	December 31, 20X0
Investments at Fair Value As Determined by Quoted Market Price		
C&H Company common stock, 25,000 shares	$ 690,000	$ 880,000
U.S. government securities	350,000	270,000
Corporate bonds and debentures	3,000,000	3,670,000
	4,040,000	4,820,000
Investments at Estimated Fair Value		
Plan interest in C&H Master Trust	2,250,000	1,860,000
Investment contract with National Insurance Company #8041A, 8.0% (Note G)	1,000,000	890,000
Corporate bonds and debentures	500,000	—
Mortgages	480,000	460,000
Real estate	270,000	240,000
	4,500,000	3,450,000
	$8,540,000	$8,270,000

During 20X1 [and 20X0], the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated in value by $278,000 [and $41,000, respectively,] as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31, 20X1	Year Ended December 31, 20X0
Investments at Fair Value as Determined by Quoted Market Price		
C&H Company common stock	$208,000	$(59,000)
U.S. government securities	20,000	40,000
Corporate bonds	10,000	—
	238,000	(19,000)
Investments at Estimated Fair Value		
Investment contract with insurance company	40,000	100,000
Corporate bonds and debentures	(50,000)	60,000
Mortgages	100,000	(90,000)
Real estate	(50,000)	(10,000)
	40,000	60,000
	$278,000	$ 41,000

F. Interest in C&H Master Trust

A portion of the Plan's investments are in the Master Trust which was established for the investment of assets of the Plan and several other C&H Company sponsored retirement plans. Each participating retirement plan has an undivided interest in the Master Trust. The assets of the Master Trust are held by GLC Trust Company (Trustee). At December 31, 20X1 and 20X0, the Plan's interest in the net assets of the Master Trust was approximately 9% and 11%, respectively. Investment income and administrative expenses relating to the Master Trust are allocated to the individual plans based upon average monthly balances invested by each plan.

The following table presents the fair values of investments for the Master Trust.

	December 31, 20X1	December 31, 20X0
Investments at fair value:		
Common stocks	$11,900,000	$ 8,800,000
Corporate bonds	11,800,000	6,700,000
U.S. government securities	867,000	750,000
	$24,567,000	$16,250,000

Investment income for the Master Trust is as follows:

	Year Ended December 31, 20X1	Year Ended December 31, 20X0
Investment income:		
Net appreciation in fair value of investments:		
Common stocks	$ 300,000	$ 200,000
Corporate bonds	200,000	200,000
U.S. government securities	300,000	200,000
	800,000	600,000
Interest	400,000	300,000
Dividends	230,000	300,000
	$1,430,000	$1,200,000

G. Contract With Insurance Company

In 20W8, the Company entered into an investment contract with the National Insurance Company under which the Plan deposits a minimum of $100,000 a year. National maintains the contributions in an unallocated fund to which it adds interest at a rate of 8%. The interest rate is guaranteed through 20X3 but is subject to change for each succeeding five-year period. When changed, the new rate applies only to funds deposited from the date of change. At the direction of the Plan's administrator, a single premium to buy an annuity for a retiring employee is withdrawn by National from the unallocated fund. Purchased annuities are contracts under which National is obligated to pay benefits to named employees or their beneficiaries. The premium rates for such annuities to be purchased in the future and maximum administration expense charges against the fund are also guaranteed by National on a five-year basis.

The annuity contracts provide for periodic dividends at National's discretion on the basis of its experience under the contracts. Such dividends received by the Plan for the year(s) ended December 31, 20X1 [and 20X0] were $25,000 [and $24,000, respectively]. In reporting changes in net assets, those dividends have been netted against amounts paid to National for the purchase of annuity contracts.

H. Plan Amendment

Effective July 1, 20X1, the Plan was amended to increase future annual pension benefits from 1 ¼% to 1 ½% of final 5-year average annual compensation for each year of service, including service rendered before the effective date. The retroactive effect of the Plan amendment, an increase in the actuarial present value of accumulated plan benefits of $2,410,000, was accounted for in the year ended December 31, 20X1. [The actuarial present value of accumulated plan benefits at December 31, 20X0 do not reflect the effect of that Plan amendment. The Plan's actuary estimates that the amendment's retroactive effect on the actuarial present value of accumulated plan benefits at December 31, 20X0 was an increase of approximately $1,750,000, of which approximately $1,300,000 represents an increase in vested benefits.]

I. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated June 30, 20XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Exhibit D-9*

C&H COMPANY PENSION PLAN

STATEMENT OF NET ASSETS AVAILABLE FOR PENSION BENEFITS

	December 31,	
	20X1	20X0
Assets		
Investments, at fair value (Note A):		
Plan interest in C&H Master Trust	$2,000,000	$1,660,000
C&H Company common stock	600,000	800,000
Investment contract with insurance company	850,000	800,000
Corporate bonds and debentures	3,000,000	3,170,000
U.S. government securities	300,000	200,000
Mortgages	480,000	460,000
Money market fund	270,000	240,000
Total investments	7,500,000	7,330,000
Net assets held in 401(h) account (Note H)	1,072,000	966,000
Receivables:		
Employer's contribution	20,000	10,000
Securities sold	310,000	175,000
Accrued interest and dividends	70,000	70,000
Total receivables	400,000	255,000
Cash	180,000	80,000
Total assets	9,152,000	8,631,000
Liabilities		
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	70,000	25,000
Amounts related to obligation of 401(h) account	1,072,000	966,000
Total liabilities	1,212,000	1,451,000
Net assets available for pension benefits	$7,940,000	$7,180,000

The accompanying notes are an integral part of the financial statements.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

Exhibit D-10*

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR PENSION BENEFITS

	For the Year Ended December 31, 20X1
Investment income:	
Net appreciation in fair value of investments	$ 233,000
Interest	293,000
Dividends	4,000
	530,000
Less investment expenses	30,000
	500,000
Plan interest in C&H Master Trust investment income (Note F)	117,000
	617,000
Contributions (Note C):	
Employer	740,000
Employees	450,000
	1,190,000
Total additions	1,807,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	50,000
Total deductions	1,047,000
Net increase	760,000
Net assets available for pension benefits:	
Beginning of year	7,180,000
End of year	$7,940,000

The accompanying notes are an integral part of the financial statements.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

Exhibit D-11*

C&H COMPANY PENSION PLAN

NOTES TO FINANCIAL STATEMENTS

A. 401 (h) Account

Effective January 1, 20X0, the Plan was amended to include a medical-benefit component in addition to the normal retirement benefits to fund a portion of the postretirement obligations for retirees and their beneficiaries in accordance with Section 401(h) of the Internal Revenue Code (IRC). A separate account has been established and maintained in the Plan for the net assets related to the medical-benefit component (401(h) account). In accordance with IRC Section 401(h), the Plan's investments in the 401(h) account may not be used for, or diverted to, any purpose other than providing health benefits for retirees and their beneficiaries. Any assets transferred to the 401(h) account from the defined benefit pension plan in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used during the plan year must be transferred out of the account to the pension plan. The related obligations for health benefits are not included in this Plan's obligations in the statement of accumulated plan benefits but are reflected as obligations in the financial statements of the health and welfare benefit plan. Plan participants do not contribute to the 401(h) account. Employer contributions or qualified transfers to the 401(h) account are determined annually and are at the discretion of the Plan Sponsor. Certain of the Plan's net assets are restricted to fund a portion of postretirement health benefits for retirees and their beneficiaries in accordance with IRC Section 401(h).

H. Reconciliation of Financial Statements to Form 5500[105]

The following is a reconciliation of net assets available for pension benefits per the financial statements to the Form 5500:

	December 31,	
	20X1	20X0
Net assets available for pension benefits per the financial statements	$7,940,000	$7,180,000
Net assets held in 401(h) account included as assets in Form 5500	1,072,000	966,000
Net assets available for benefits per the Form 5500	$9,012,000	$8,146,000

The net assets of the 401(h) account included in Form 5500 are not available to pay pension benefits but can be used only to pay retiree health benefits.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

105 The reconciliation of amounts reported in the plan's financial statements to amounts reported in Form 5500 is required by ERISA.

The following is a reconciliation of the changes in net assets per the financial statements to the Form 5500:

	For the Year Ended December 31, 20X1		
	Amounts per Financial Statements	401(h) Account	Amounts per Form 5500
Net appreciation in fair value of investments	$233,000	$10,800	$243,800
Interest income	293,000	80,200	373,200
Employer contributions	740,000	40,000	780,000
Benefits paid to retirees	740,000	10,000	750,000
Administrative expenses	50,000	15,000	65,000

Appendix E

Illustrations of Financial Statements: Defined Contribution Plans

E.01 This appendix illustrates certain applications of the provisions of chapter 3 that apply for the annual financial statements of hypothetical defined contribution pension plans with participant-directed and nonparticipant-directed investments. Such illustrative plans include the XYZ Company 401(k) Plan (exhibits E-1 through E-3), the XYZ Company Profit-Sharing Plan (exhibits E-4 through E-6) and the Sponsor Company Employee Stock Ownership Plan (exhibits E-7 through E-9). It does not illustrate other provisions of chapter 3 that might apply in circumstances other than those assumed in this example. The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

E.02 Although generally accepted accounting principles do not require comparative financial statements, ERISA requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

E.03 ERISA and DOL regulations require that certain information be included in supplemental schedules, which are not required under generally accepted accounting principles, and reported on by the independent auditor. See appendix A for a further discussion of the ERISA and DOL requirements.

CONTENTS

Exhibit E-1

XYZ Company 401(k) Plan
Statements of Net Assets Available for Benefits

	December 31,	
	20X1	*20X0*
Assets		
Investments (See Note C)	$9,177,000	$7,995,000
Receivables:		
Employer contribution	14,000	10,000
Participant contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,243,000	8,055,000
Liabilities:		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits	$9,218,000	$8,035,000

See accompanying notes to the financial statements.

Exhibit E-2

XYZ Company 401(k) Plan
Statement of Changes in Net Assets Available for Benefits

	Year Ended December 31, 20X1
Additions:	
Additions to net assets attributed to:	
Investment income:	
Net appreciation in fair value of investments (see Note C)	$ 279,000
Interest	439,000
Dividends	165,000
	883,000
Less investment expenses	(50,000)
	833,000
Contributions:	
Participant	900,000
Employer	699,000
	1,599,000
Total additions	2,432,000
Deductions:	
Deductions from net assets attributed to:	
Benefits paid to participants	1,144,000
Administrative expenses (see Note F)	105,000
Total deductions	1,249,000
Net increase	1,183,000
Net assets available for benefits:	
Beginning of year	8,035,000
End of year	$9,218,000

See accompanying notes to the financial statements.

Exhibit E-3

XYZ Company 401(k) Plan

Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company ("Company") 401(k) Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act (ERISA).
2. *Contributions.* Each year, participants may contribute up to 12 percent of pretax annual compensation, as defined in the Plan. Participants may also contribute amounts representing distributions from other qualified defined benefit or defined contribution plans. Participants direct the investment of their contributions into various investment options offered by the Plan. The Plan currently offers two mutual funds and an insurance investment contract as investment options for participants. The Company contributes 25 percent of the first 6 percent of base compensation that a participant contributes to the Plan. The matching Company contribution is invested directly in XYZ Company common stock. Additional profit sharing amounts may be contributed at the option of the Company's board of directors and are invested in a portfolio of investments as directed by the Company. Contributions are subject to certain limitations.
3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and allocations of (*a*) the Company's contribution and (*b*) Plan earnings, and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.
4. *Vesting.* Participants are vested immediately in their contributions plus actual earnings thereon. Vesting in the Company's contribution portion of their accounts is based on years of continuous service. A participant is 100 percent vested after five years of credited service.
5. *Participant Loans.* Participants may borrow from their fund accounts a minimum of $1,000 up to a maximum equal to the lesser of $50,000 or 50 percent of their account balance, whichever is less. The loans are secured by the balance in the participant's account and bear interest at rates that range from 6 percent to 10 percent, which are commensurate with local prevailing rates as determined quarterly by the Plan administrator. Principal and interest is paid ratably through monthly payroll deductions.
6. *Payment of Benefits.* On termination of service due to death, disability, or retirement, a participant may elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or annual installments over a ten-year period. For termination of service for other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

7. *Forfeited Accounts.* At December 31, 20X1 forfeited nonvested accounts totaled $7,500. These accounts will be used to reduce future employer contributions. Also, in 20X1, employer contributions were reduced by $5,000 from forfeited nonvested accounts.

B. Summary of Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Investment Valuation and Income Recognition

The Plan's investments are stated at fair value except for its benefit-responsive investment contract, which is valued at contract value (Note E). Quoted market prices are used to value investments. Shares of mutual funds are valued at the net asset value of shares held by the Plan at year end.

Purchases and sales of securities are recorded on a trade-date basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

C. Investments

The following presents investments that represent 5 percent or more of the Plan's net assets.

	December 31,	
	20X1	*20X0*
XYZ Company common stock, 400,000 and 390,000 shares, respectively	$ 470,000*	$ 420,000*
ABC Corporation common stock, 390,000 and 380,000 shares, respectively	490,000*	450,000*
Prosperity Investments Common Stock Fund, 226,250 and 200,000 shares, respectively	2,262,500*	2,000,000*
Prosperity Investments Balanced Fund, 40,000 and 210,000 shares, respectively	1,422,000	2,100,000
Investment Contract with National Insurance Company, #2012A, matures 12/31/X5 (Note E)	1,500,000	650,000

* Nonparticipant-directed

During 20X1, the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated in value by $279,000 as follows:

Mutual funds	$229,000
Common stock	30,000
Corporate bond	30,000
U.S. Government Securities	(10,000)
	$279,000

D. Nonparticipant-Directed Investments

Information about the net assets and the significant components of the changes in net assets relating to the nonparticipant-directed investments is as follows:

	December 31, 20X1	December 31, 20X0
Net Assets:		
Common stock	$ 960,000	$ 870,000
Mutual funds	2,262,500	2,000,000
Corporate bonds	307,500	255,000
U.S. Government Securities	225,000	120,000
	$3,755,000	$3,245,000

	Year Ended December 31, 20X1
Changes in Net Assets:	
Contributions	$ 699,000
Dividends	165,000
Net appreciation	60,000
Benefits paid to participants	(280,000)
Transfers to participant-directed investments	(134,000)
	$ 510,000

E. Investment Contract with Insurance Company

In 20X0, the Plan entered into a benefit-responsive investment contract with National Insurance Company (National). National maintains the contributions in a general account. The account is credited with earnings on the underlying investments and charged for participant withdrawals and administrative expenses. The contract is included in the financial statements at contract value as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less participant withdrawals and administrative expenses. Participants may ordinarily direct the withdrawal or transfer of all or a portion of their investment at contract value.

There are no reserves against contract value for credit risk of the contract issuer or otherwise. The average yield and crediting interest rates were approximately 8 percent for 20X1 and 20X0. The crediting interest rate is based on a formula agreed upon with the issuer, but may not be less than 4 percent. Such interest rates are reviewed on a quarterly basis for resetting.

F. Related-Party Transactions

Certain Plan investments are shares of mutual funds managed by Prosperity Investments. Prosperity Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest transactions. Fees paid by the Plan for the investment management services amounted to $105,000 for the year ended December 31, 20X1.

G. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants would become 100 percent vested in their employer contributions.

H. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated August 30, 1986, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). Although the Plan has been amended since receiving the determination letter, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Profit-Sharing Plan

Exhibit E-4

XYZ Company Profit-Sharing Plan
Statements of Net Assets Available for Benefits

	December 31, 20X1	December 31, 20X0
Assets		
Investments:		
At fair value—(Notes B, C, and E)		
U.S. government securities	$ 455,000	$ 425,000
Corporate bonds and debentures	3,900,000	3,730,000
Common stocks	2,822,000	1,931,000
Certificates of deposit	1,000,000	1,000,000
	8,177,000	7,086,000
At contract value—(Note D)		
Investment contract with insurance company	1,000,000	1,000,000
Total investments	9,177,000	8,086,000
Receivables:		
Employer's contribution	14,000	12,000
Participants' contributions	52,000	47,000
Due from broker for securities sold	403,000	357,000
Accrued interest and dividends	77,000	62,000
	546,000	478,000
Cash	280,000	198,000
Total assets	10,003,000	8,762,000
Liabilities		
Accounts payable	10,000	8,000
Accrued expenses	100,000	150,000
Due to broker for securities purchased	75,000	63,000
Total liabilities	185,000	221,000
Net assets available for benefits	$ 9,818,000	$8,541,000

The accompanying notes are an integral part of these financial statements.

Exhibit E-5

XYZ Company Profit-Sharing Plan
Statement of Changes in Net Assets Available for Benefits

	Year Ended December 31, 20X1
Additions to net assets attributed to:	
Investment income:	
Net appreciation in fair value of investments (Note C)	$ 269,000
Interest	449,000
Dividends	165,000
	883,000
Less investment expenses	(50,000)
	833,000
Contributions:	
Employer's	1,014,000
Participants'	585,000
	1,599,000
Total additions	2,432,000
Deductions from net assets attributed to:	
Benefits paid to participants	1,050,000
Administrative expenses	105,000
Total deductions	1,155,000
Net increase	1,277,000
Net assets available for plan benefits:	
Beginning of year	8,541,000
End of year	$9,818,000

The accompanying notes are an integral part of these financial statements.

Exhibit E-6

XYZ Company Profit-Sharing Plan
Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company ("Company") Profit-Sharing Plan ("Plan") provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).
2. *Contributions.* Each year, the Company contributes to the Plan 10 percent of its current profits before pension and profit-sharing costs and income taxes. Additional amounts may be contributed at the option of the Company's board of directors. Participants may contribute up to 10 percent of their annual wages before bonuses and overtime. Contributions are subject to certain limitations.
3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and an allocation of (*a*) the Company's contribution, (*b*) Plan earnings, and (*c*) forfeitures of terminated participants' nonvested accounts and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.
4. *Vesting.* Participants are immediately vested in their voluntary contributions plus actual earnings thereon. Vesting in the Company contributions portion of their accounts plus earnings thereon is based on years of continuous service. A participant is 100 percent vested after five years of credited service.
5. *Payment of Benefits.* On termination of service due to death, disability or retirement, a participant may elect to receive an amount equal to the value of the participant's vested interest in his or her account in either a lump-sum amount, or in annual installments over a ten year period. For termination of service due to other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.
6. *Forfeited Accounts.* At December 31, 20X1 forfeited nonvested accounts totaled $10,000. These accounts will be reallocated to participants in the same manner as employer contributions.

B. Summary of Accounting Policies

Basis of Accounting

The financial statements of the Plan are prepared under the accrual method of accounting.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Investment Valuation and Income Recognition
The Plan's investments are stated at fair value except for its investment contract which is valued at contract value with an insurance company (Note D). If available, quoted market prices are used to value investments. The amounts shown in Note C for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices. Certificates of deposit are valued based on amortized cost or original cost plus accrued interest.
Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits
Benefits are recorded when paid.

C. Investments

Except for its investment contract with an insurance company (Note D), the Plan's investments are held in a bank-administered trust fund. The following table presents investments. Investments that represent 5 percent or more of the Plan's net assets are separately identified.

	December 31, 20X1	December 31, 20X0
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities	$ 455,000	$ 425,000
Corporate bonds and debentures:		
National Auto 7%, face value of $860,000 and $1,000,000, respectively, bonds due 12/31/X5	875,000	1,226,000
Other	2,775,000	2,328,000
Common stocks:		
Bizco Corporation, 100,000 and 90,000 shares, respectively	950,000	685,000
Other	1,497,000	981,000
	6,552,000	5,645,000
Investments at Estimated Fair Value		
Certificates of Deposit	1,000,000	1,000,000
Corporate bonds and debentures	250,000	176,000
Common stocks	375,000	265,000
	1,625,000	1,441,000
Investment at Contract Value		
Investment contract with National Insurance Company, #2012A, matures 12/31/X2 (Note D)	1,000,000	1,000,000
Total investments	$9,177,000	$8,086,000

During 20X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $269,000 as follows:

Net Change in Fair Value

	Year Ended December 31, 20X1
Investments at Fair Value as Determined by Quoted Market Price	
U.S. government securities	$ (15,000)
Corporate bonds and debentures	(175,000)
Common stocks	439,000
Net change in fair value	249,000
Investments at Estimated Fair Value	
Corporate bonds and debentures	(5,000)
Common stocks	25,000
	20,000
Net change in fair value	$ 269,000

D. Investment Contract With Insurance Company

In 20X0, the Plan entered into an investment contract with National Insurance Company (National). National maintains the contributions in a pooled account. The account is credited with earnings on the underlying investments and charged for Plan withdrawals and administrative expenses charged by National. The contract is included in the financial statements at contract value, (which represents contributions made under the contract, plus earnings, less withdrawals and administrative expenses) because it is fully benefit responsive. For example, participants may ordinarily direct the withdrawal or transfer of all or a portion of their investment at contract value. There are no reserves against contract value for credit risk of the contract issuer or otherwise. The fair value of the investment contract at December 31, 20X1 and 20X0 was $1,082,000 and $1,040,000, respectively. The average yield and crediting interest rates were approximately five percent for 20X1 and 20X0. The crediting interest rate is based on an agreed-upon formula with the issuer, but cannot be less than zero.

E. Certificates of Deposit

Certificates of deposit at December 31, 20X1 and 20X0 consist of amounts on deposit at banks or savings and loan associations, with interest rates ranging from 5.4 percent to 9.1 percent, with maturities of three months or less. These deposits include $400,000 and $500,000 which are in excess of federally insured limits at December 31, 20X1 and 20X0, respectively.

F. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100 percent vested in their accounts. Any unallocated assets of the plan shall be allocated to participant accounts and distributed in such a manner as the company may determine.

G. Tax Status

The Internal Revenue Service has determined and informed the Company by letter dated August 30, 20XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable provisions of the IRC.

H. Reconciliation of Financial Statements to 5500

The following is a reconciliation of net assets available for benefits per the financial statements at December 31, 20X1 and 20X0 to Form 5500:

	20X1	*20X0*
Net assets available for benefits per the financial statements	$9,818,000	$8,541,000
Amounts allocated to withdrawing participants	(50,000)	(35,000)
Net assets available for benefits per the Form 5500	$8,768,000	$8,506,000

The following is a reconciliation of benefits paid to participants per the financial statements for the year ended December 31, 20X1, to Form 5500:

Benefits paid to participants per the financial statements	$1,050,000
Add: Amounts allocated to withdrawing participants at December 31, 20X1	50,000
Less: Amounts allocated to withdrawing participants at December 21, 20X0	(35,000)
Benefits paid to participants per Form 5500	$1,065,000

Amounts allocated to withdrawing participants are recorded on the Form 5500 for benefit claims that have been processed and approved for payment prior to December 31, 20X1, but not yet paid as of that date.

Employee Stock Ownership Plan

Exhibit E-7

Sponsor Company Stock Ownership Plan
Statements of Net Assets Available for Benefits*

	December 31,					
	20X2			*20X1*		
	Allocated	Unallocated	Total	Allocated	Unallocated	Total
Assets:						
Investment in sponsor company common stock, at fair value	$34,890,000	$57,430,000	$ 92,320,000	$24,568,000	$ 47,015,000	$71,583,000
Receivables:						
Employer contributions	—	8,607,000	8,607,000	—	7,062,000	7,062,000
Dividends and interest	570,000	459,000	1,029,000	280,000	3,000	283,000
Cash and cash equivalents	156,000	863,000	1,019,000	101,000	448,000	549,000
Total assets	$35,616,000	$67,359,000	$102,975,000	$24,949,000	$ 54,528,000	$79,477,000
Liabilities:						
Interest payable	—	1,396,000	1,396,000	—	1,033,000	1,033,000
Loan payable	—	73,970,000	73,970,000	—	80,000,000	80,000,000
Total liabilities	—	75,366,000	75,366,000	—	81,033,000	81,033,000
Net assets available (deficit) for plan benefits	$35,616,000	$ (8,007,000)	$ 27,609,000	$24,949,000	$(26,505,000)	$ (1,556,000)

The accompanying notes are an integral part of these financial statements.

* The columns reflected in the example are appropriate for the presentation of a leveraged ESOP. For a non-leveraged ESOP, the presentation would reflect only the total column without the segregation between allocated and unallocated.

Allocated and unallocated designations distinguish between assets that belong to plan participants and those that are still available as collateral for the ESOP loan. Under ERISA, the lender has access to the securities held by the plan, that represent unallocated employer contributions to service the debt, and any earnings on those amounts. Earnings on temporary cash investments also are available to the lender.

An accrued employer contribution for current or future debt service is, therefore, reflected on the Statement of Net Assets Available for Benefits and the Statement of Changes in Net Assets Available for Benefits in the Unallocated column. In contrast, an employer contribution accrued to fund distributions to terminated participants is reflected in the Allocated column.

This distinction is *not* reflected in the participant account balances when reporting to the participant under ERISA. Contributions accrued for future debt service are allocated to the accounts of plan participants.

Exhibit E-8

Sponsor Company Stock Ownership Plan
Statement of Changes in Net Assets Available for Benefits

	December 31, 20X2		
	Allocated	Unallocated	Total
Investment income:			
Net unrealized appreciation in market value of investments	$ 9,205,000	$15,052,000	$24,257,000
Interest	31,000	58,000	89,000
Dividends	1,380,000	2,184,000	3,564,000
Employer contributions	—	11,524,000	11,524,000
Allocation of 142,000 shares of common stock of Sponsor Company, at market	4,637,000	—	4,637,000
	15,253,000	28,818,000	44,071,000
Interest expense	—	5,683,000	5,683,000
Distributions to participants	4,586,000	—	4,586,000
Allocation of 142,000 shares of common stock of Sponsor Company, at market	—	4,637,000	4,637,000
Total deductions	4,586,000	10,320,000	14,906,000
Net increase	10,667,000	18,498,000	29,165,000
Net assets (deficit) available for benefits:			
Beginning of year	24,949,000	(26,505,000)	(1,556,000)
End of year	$35,616,000	$ (8,007,000)	$27,609,000

The accompanying notes are an integral part of these financial statements.

Exhibit E-9

Sponsor Company Stock Ownership Plan

Notes to Financial Statements

December 31, 20X2

1. **Plan Description and Basis of Presentation**

The Sponsor Company (Company) established the Sponsor Company Stock Ownership Plan (Plan) effective as of January 1, 20XX. As of January 1, 20XY, the Plan was amended and operates, in relevant part, as a leveraged employee stock ownership plan (ESOP), and is designed to comply with Section 4975(e)(7) and the regulations thereunder of the Internal Revenue Code of 1986, as amended (Code) and is subject to the applicable provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). The Plan is administered by an Employee Benefits Administration Committee comprising up to three persons appointed by the Sponsor Company's Board of Directors. The trust department of an independent third-party bank is the Plan's Trustee.

The Plan purchased Company common shares using the proceeds of a bank borrowing (see Note 6) guaranteed by the Company, and holds the stock in a trust established under the Plan. The borrowing is to be repaid over a period of ten years by fully deductible Company contributions to the trust fund. As the Plan makes each payment of principal, an appropriate percentage of stock will be allocated to eligible employees' accounts in accordance with applicable regulations under the Code. Shares vest fully upon allocation.

The borrowing is collateralized by the unallocated shares of stock and is guaranteed by the Company. The lender has no rights against shares once they are allocated under the ESOP. Accordingly, the financial statements of the Plan for the years 20X2 and 20X1 present separately the assets and liabilities and changes therein pertaining to:

(*a*) the accounts of employees with vested rights in allocated stock (Allocated) and

(*b*) stock not yet allocated to employees (Unallocated).

Employees of the Company and its participating subsidiaries are generally eligible to participate in the Plan after one year of service providing they worked at least 1,000 hours during such plan year. Participants who do not have at least 1,000 hours of service during such plan year or are not employed on the last working day of a plan year are generally not eligible for an allocation of Company contributions for such year.

No distributions from the Plan will be made until a participant retires, dies (in which case, payment shall be made to his or her beneficiary or, if none, his or her legal representatives), or otherwise terminates employment with the Company and its participating subsidiaries. Distributions are made in cash or, if a participant elects, in the form of Company common shares plus cash for any fractional share.

Each participant is entitled to exercise voting rights attributable to the shares allocated to his or her account and is notified by the Trustee prior to the time that such rights are to be exercised. The Trustee is not permitted to vote any share for which instructions have not been given by a participant.

The Company reserves the right to terminate the Plan at any time, subject to Plan provisions. Upon such termination of the Plan, the interest of each participant in the trust fund will be distributed to such participant or his or her beneficiary at the time prescribed by the Plan terms and the Code. Upon termination of the Plan, the Employee Benefits Administration Committee shall direct the Trustee to pay all liabilities and expenses of the trust fund and to sell shares of financed stock held in the loan suspense account to the extent it determines such sale to be necessary in order to repay the loan.

2. **Summary of Significant Accounting Policies**

Basis of Accounting

The financial statements of the plan are prepared using the accrual method of accounting.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Investment Valuation and Income Recognition

The common shares of the Company are valued at fair value on December 31, 20X2 and 20X1. Fair value is determined by annual independent appraisals.

Dividend income is accrued on the ex-dividend date.

Purchases and sales of securities are recorded on a trade-date basis. Realized gains and losses from security transactions are reported on the average cost method.

3. **Tax Status**

The Internal Revenue Service has determined and informed the Company by a letter dated June 30, 20XX, that the Plan is qualified and the trust established under the Plan is tax-exempt, under the appropriate sections of the Code. The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the Code. Therefore, they believe that the Plan was qualified and the related trust was tax-exempt as of the financial statement date.

4. **Administration of Plan Assets**

The Plan's assets, which consist principally of Sponsor Company common shares, are held by the Trustee of the Plan.

Company contributions are held and managed by the Trustee, which invests cash received, interest, and dividend income and makes distributions to participants. The Trustee also administers the payment of interest and principal on the loan, which is reimbursed to the Trustee through contributions as determined by the Company.

Certain administrative functions are performed by officers or employees of the Company or its subsidiaries. No such officer or employee receives compensation from the Plan. Administrative expenses for the Trustee's fees are paid directly by the Company.

5. **Investments**

The Plan's investments, at December 31, are presented in the following table:

	20X2		*20X1*	
	Allocated	Unallocated	Allocated	Unallocated
Sponsor Company Common Shares:				
Number of Shares	1,069,000	1,759,000	1,074,000	2,055,000
Cost	$27,014,000	$74,456,000	$29,910,000	$80,000,000
Market	$34,890,000	$57,430,000	$24,568,000	$47,015,000

6. **Loan Payable**

In 20XX, the Plan entered into an $80,000,000 term loan agreement with a bank. The proceeds of the loan were used to purchase Company's common stock. Unallocated shares are collateral for the loan. The agreement provides for the loan to be repaid over ten years. The scheduled amortization of the loan for the next five years and thereafter is as follows: 20X3—$6,500,000; 20X4—$7,000,000; 20X5—$7;500,000; 20X6—$8,000,000; 20X7—$8,500,000; and thereafter—$31,470,900. The loan bears interest at the prime rate of the lender. For 20X2 and 20X1 the loan interest rate averaged 7.34 percent and 5.12 percent, respectively.

7. **Employer Contributions**

The Company is obligated to make contributions in cash to the Plan which, when aggregated with the Plan's dividends and interest earnings, equal the amount necessary to enable the Plan to make its regularly scheduled payments of principal and interest due on its term loan.

Appendix F

Illustrations of Financial Statements: Employee Health and Welfare Benefit Plans

F.01 This appendix illustrates certain applications of the provisions of chapter 4 to the annual financial statements of two hypothetical health and welfare benefit plans that have assets in underlying trusts. They are—

a. Allied Industries Benefit Plan, a multiemployer plan that displays the benefit obligation information in separate financial statements (exhibits F-1 through F-5).

b. Classic Enterprises Benefit Plan, a single-employer plan that displays the benefit obligation information on the face of the financial statements along with the net asset information (exhibits F-6 through F-8).

F.02 The plan in exhibits F-1 through F-5 pays all benefits directly from plan assets. The plan in exhibits F-6 through F-8 obtains insurance for current benefits from its assets. It is assumed that both plans provide health benefits and life insurance coverage to both active and retired participants. Exhibits F-1 through F-5 also assume that the plan provides long-term disability benefits and limited coverage during periods of unemployment based on accumulated eligibility credits.

F.03 This appendix also illustrates certain applications of the provisions of SOP 99-2 that apply for the annual financial statements of a hypothetical health and welfare benefit plan that includes retiree health benefits that are funded partially through a 401(h) account in the plan sponsor's defined benefit pension plan (Exhibits F-9 through F-13). It illustrates the single line approach to presenting information about the 401(h) account permitted by paragraph 11 of the SOP. It does not illustrate other provisions of the SOP that might apply in circumstances other than those assumed in the illustration. It also does not illustrate all disclosures required for a fair presentation in conformity with GAAP. The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

F.04 The examples do not illustrate other provisions of chapter 4 that might apply in circumstances other than those assumed. The format presented and the wording of the accompanying notes are illustrative only and are not necessarily the only possible presentations. Although generally accepted accounting principles encourage but do not require comparative financial statements ERISA requires comparative statements of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

F.05 ERISA and DOL regulations require that certain information be included in supplemental schedules, which are not required under generally accepted accounting principles, and reported on by the independent auditor. See appendix A for a further discussion of the ERISA and DOL requirements.

CONTENTS

Illustrations of Financial Statements: Health and Welfare Benefit Plans

Exhibit F-1

ALLIED INDUSTRIES BENEFIT PLAN
Allied Industries Benefit Plan
Statements of Net Assets Available for Benefits
December 31, 20X1 and 20X0

	20X1	*20X0*
Assets		
Investments, at fair value (see note 4)		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total Investments	8,000,000	6,200,000
Receivables		
Participating employers' contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	140,000	115,000
TOTAL ASSETS	8,790,000	6,865,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
TOTAL LIABILITIES	275,000	265,000
NET ASSETS AVAILABLE FOR BENEFITS	$8,515,000	$6,600,000

The accompanying notes are an integral part of the financial statements.

Exhibit F-2

Allied Industries Benefit Plan
Statement of Changes in Net Assets Available for Benefits
Year Ended December 31, 20X1

	20X1
Additions	
Contributions	
Participating employers	$15,000,000
Participants	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
Total investment income	850,000
Less investment expenses	15,000
Net investment income	835,000
TOTAL ADDITIONS	18,835,000
Deductions	
Benefits paid to participants	
Health care	16,000,000
Disability and death	770,000
Total benefits paid	16,770,000
Administrative expenses	150,000
TOTAL DEDUCTIONS	16,920,000
NET INCREASE DURING YEAR	1,915,000
Net assets available for benefits	
Beginning of year	6,600,000
End of year	$ 8,515,000

The accompanying notes are an integral part of the financial statements.

Exhibit F-3

Allied Industries Benefit Plan
Statements of Plan's Benefit Obligations
December 31, 20X1 and 20X0

	20X1	*20X0*
Amounts currently payable to or for participants, beneficiaries, and dependents		
Health claims payable	$ 1,100,000	$ 975,000
Death and disability benefits payable	100,000	75,000
	1,200,000	1,050,000
Other obligations for current benefit coverage, at present value of estimated amounts		
Claims incurred but not reported	350,000	290,000
Accumulated eligibility credits	200,000	225,000
Long-term disability benefits	800,000	485,000
	1,350,000	1,000,000
Total obligations other than postretirement benefit obligations	2,550,000	2,050,000
Postretirement benefit obligations		
Current retirees	3,900,000	3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Other participants not yet fully eligible for benefits	5,000,000	4,165,000
	11,000,000	9,665,000
PLAN'S TOTAL BENEFIT OBLIGATIONS	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

Exhibit F-4

Allied Industries Benefit Plan
Statement of Changes in Plan's Benefit Obligations
Year Ended December 31, 20X1

	20X1
Amounts currently payable to or for participants, beneficiaries, and dependents	
Balance at beginning of year	$ 1,050,000
Claims reported and approved for payment	16,920,000
Claims paid (including disability)	(16,770,000)
Balance at end of year	1,200,000
Other obligations for current benefit coverage, at present value of estimated amounts	
Balance at beginning of year	1,000,000
Net change during year:	
Long-term disability benefits	315,000
Other	35,000
Balance at end of year	1,350,000
Total obligations other than postretirement benefit obligations	2,550,000
Postretirement benefit obligation	
Balance at beginning of year	9,665,000
Increase (decrease) during the year attributable to:	
Benefits earned and other changes	1,250,000
Plan amendment	(175,000)
Changes in actuarial assumptions	260,000
Balance at end of year	11,000,000
PLAN'S TOTAL BENEFIT OBLIGATIONS AT END OF YEAR	$13,550,000

The accompanying notes are an integral part of the financial statements.

Exhibit F-5

Allied Industries Benefit Plan

Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

The following description of the Allied Industries Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

General. The Plan provides health and other benefits covering all participants in the widgets industry in the Greater Metropolis area. The Plan and related trust were established on May 8, 1966, pursuant to a collective bargaining agreement between the Allied Employers' Trade Association and the Allied Union, Local 802. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Benefits. The Plan provides health benefits (medical, hospital, surgical, major medical, and dental), life insurance coverage, long-term disability benefits, and death benefits to full-time participants (with at least 450 hours of work in the industry during a consecutive three-month period) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health benefits (in excess of Medicare coverage) provided they have attained at least age sixty-two and have fifteen years of service with participating employers before retirement.

The Plan also provides health benefits to participants during periods of unemployment, provided they have accumulated in the current year or in prior years credit amounts (expressed in hours) in excess of the hours required for current coverage. Accumulated eligibility credits equal to one year's coverage may be carried forward.

Health, disability, and death claims of active and retired participants, dependents, and beneficiaries are processed by the Administrator Group, but the responsibility for payments to participants and providers is retained by the Plan.

In 20X1 the board of trustees amended the Plan to increase the deductible under major medical coverage from $100 to $300 and to extend dental coverage to employees retiring after December 31, 20X2. The amendment will not affect participating employers' contributions to the Plan in 20X2 under the current collective bargaining agreement.

Contributions. Participating employers contribute 5.5 percent of wages pursuant to the current collective bargaining agreement between employers and the union (expiring February 19, 20X5). Employees and retirees may contribute specified amounts, determined periodically by the Plan's actuary, to extend coverage to eligible dependents.

Other. The Plan's board of trustees, as Sponsor, has the right under the Plan to modify the benefits provided to active employees. The Plan may be terminated only by joint agreement between industry and union, subject to the provisions set forth in ERISA.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

A. Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, benefit obligations, and changes therein, IBNR, eligibility credits, claims payable, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

B. Valuation of Investments. The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Plan's board of trustees has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

C. Postretirement Benefits. The postretirement benefit obligation represents the total actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired or terminated employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the participating employers. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service in the industry rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment.

For measurement purposes, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 20X2; the rate was assumed to decrease gradually to 8.0 percent for 20X7 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 20X1.

The following were other significant assumptions used in the valuations as of December 31, 20X1 and 20X0.

Weighted-average discount rate	8.0%—20X1; 8.25%—20X0
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

D. Other Plan Benefits. Plan obligations at December 31 for health claims incurred by active participants but not reported at that date, for accumulated eligibility of participants, and for future disability payments to members considered permanently disabled at December 31 are estimated by the Plan's actuary in accordance with accepted actuarial principles. Such estimated amounts are reported in the accompanying statement of the Plan's benefit obligations at present value, based on an 8.0 percent discount rate. Health claims incurred by retired participants but not reported at year end are included in the postretirement benefit obligation.

NOTE 3: BENEFIT OBLIGATIONS

The Plans deficiency of net assets over benefit obligations at December 31, 20X1 and 20X0, relates primarily to the postretirement benefit obligation, the funding of which is not covered by the contribution rate provided by the current bargaining agreement. It is expected that the deficiency will be funded through future increases in the collectively bargained contribution rates.

The weighted-average health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported in the accompanying financial statements. If the assumed rates increased by one percentage point in each year, it would increase the obligation as of December 31, 20X1 and 20X0, by $2,600,000 and $2,500,000, respectively.

NOTE 4: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 20X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $300,000, as follows:

	20X1		*20X0*
	Net Increase (Decrease) in Value During Year	*Fair Value at End of Year*	*Fair Value at End of Year*
Fair Value as determined by quoted market price:			
U.S. government securities	$200,000	$5,000,000	$4,000,000
Corporate bonds and debentures	(25,000)	1,750,000	1,375,000
Common stocks	100,000	1,000,000	600,000
	275,000	7,750,000	5,975,000
Fair value as estimated by Plan's board of trustees:			
Corporate bonds	25,000	250,000	225,000
	$300,000	$8,000,000	$6,200,000

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets are as follows:

	20X1	*20X0*
Commonwealth Power Co., 9.0% bonds due 2014 ($500,000 face amount)	$475,000	$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 20X6 ($360,000 face amount)		350,000

NOTE 5: OTHER MATTERS

The Trust established under the Plan to hold the Plan's assets is intended to qualify pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the Trust's net investment income is exempt from income taxes. The Trust has obtained a favorable tax determination letter from the Internal Revenue Service, and the Plan sponsor believes that the Trust, as amended, continues to qualify and to operate in accordance with applicable provisions of the Internal Revenue Code.

NOTE 6: RECONCILIATION OF FINANCIAL STATEMENTS TO FORM 5500

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

	December 31,	
	20X1	*20X0*
Net assets available for benefits per the financial statements	$8,515,000	$6,600,000
Benefit obligations currently payable (health claims, death and disability benefits)	1,200,000	1,050,000
Net assets available for benefits per the Form 5500	$7,315,000	$5,550,000

The following is a reconciliation of benefits paid to participants per the financial statements to the Form 5500:

	Year ended December 31, 20X1
Benefits paid to participants per the financial statements	$16,770,000
Add: Amounts currently payable at December 31, 20X1	1,200,000
Less: Amounts currently payable at December 31, 20X0	(1,050,000)
Benefits paid to participants per the Form 5500	$16,920,000

Amounts currently payable to or for participants, dependents, and beneficiaries are recorded on the Form 5500 for benefit claims that have been processed and approved for payment prior to December 31, but not yet paid as of that date.

Exhibit F-6

CLASSIC ENTERPRISES BENEFIT PLAN

Classic Enterprises Benefit Plan
Statements of Benefit Obligations and Net Assets Available for Benefits
December 31, 20X1 and 20X0

	20X1	*20X0*
BENEFIT OBLIGATIONS (see note 3)		
Amounts due insurance companies	$ 1,200,000	$ 1,000,000
Postretirement benefit obligations	11,000,000	9,665,000
Total benefit obligations	12,200,000	10,665,000
NET ASSETS		
Assets		
Investments at fair value (see note 4)		
U.S. government securities	$ 5,000,000	$ 4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Receivables		
Sponsor's contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	75,000	60,000
Insurance premium deposits	65,000	55,000
TOTAL ASSETS	8,790,000	6,865,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
TOTAL LIABILITIES	275,000	265,000
NET ASSETS AVAILABLE FOR BENEFITS	8,515,000	6,600,000
EXCESS OF BENEFIT OBLIGATIONS OVER NET ASSETS AVAILABLE FOR BENEFITS	$ 3,685,000	$ 4,065,000

The accompanying notes are an integral part of the financial statements.

Exhibit F-7

Classic Enterprises Benefit Plan
Statement of Changes in Benefit Obligations and Net Assets Available for Benefits
Year Ended December 31, 20X1

	20X1
Net Increase in Benefit Obligations	
Increase (Decrease) during the year attributable to:	
Benefits earned and other changes	$1,510,000
Additional amounts payable to insurance company	200,000
Plan amendment	(175,000)
	1,535,000
Net Increase in Net Assets Available for Benefits	
Additions	
Contributions	
Sponsor	15,000,000
Participants	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
	850,000
Less investment expenses	15,000
Net investment income	835,000
TOTAL ADDITIONS	18,835,000

(continued)

	20X1
Deductions	
Insurance premiums paid for health benefits, net of experience-rating adjustments of $250,000 for 20X0 received in 20X1	16,035,000
Insurance premiums paid for death benefits	780,000
	16,815,000
Administrative expenses	105,000
TOTAL DEDUCTIONS	16,920,000
NET INCREASE	1,915,000
Decrease in Excess of Benefit Obligations Over Net Assets Available for Benefits	(380,000)
Excess of Benefit Obligations Over Net Assets Available for Benefits	
Beginning of year	4,065,000
End of year	$3,685,000

The accompanying notes are an integral part of the financial statements.

Exhibit F-8

Classic Enterprises Benefit Plan
Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

The following description of the Classic Enterprises Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

General. The Plan provides health and death benefits covering substantially all active and retired employees of Classic Enterprises (the Sponsor). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Benefits. The Plan provides health benefits (medical, hospital, surgical, major medical, and dental) and death benefits to full-time employees of the Sponsor (with at least 1,000 hours of service each year) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health and death benefits provided they have attained at least age fifty-five and have at least ten years of service with the Sponsor.

Current health claims of active and retired participants and their dependents and beneficiaries are provided under group insurance contracts with ABC Carrier, which are experience rated after the anniversary dates of the policies (generally March 31). Death benefits are covered by a group-term policy with DEF Carrier.

Contributions. The Sponsor's policy is to contribute the maximum amounts allowed as a tax deduction by the Internal Revenue Code. Under present law, the Sponsor is not permitted to deduct amounts for future benefits to current employees and retirees.

Employees and retirees may contribute specified amounts, determined periodically by the Plan's insurance companies, to extend coverage to eligible dependents.

In 20X1 the Plan was amended to increase the deductible under major medical coverage from $100 to $300 and to extend dental coverage to employees retiring after December 31, 20X1. The amendment is not expected to significantly affect the Sponsor's contribution to the Plan in 20X2.

Other. Although it has not expressed any intention to do so, the Sponsor has the right under the Plan to modify the benefits provided to active employees, to discontinue its contributions at any time, and to terminate the Plan subject to the provisions set forth in ERISA.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

A. Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, benefit obligations and changes therein, IBNR, eligibility credits, claims payable, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

B. Valuation of Investments. The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Classic Enterprises Benefits Committee has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

C. Plan Benefits. The postretirement benefit obligation (see note 3) represents the actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the Sponsor. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment.

For measurement purposes at December 31, 20X1, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 20X2; the rate was assumed to decrease gradually to 8.0 percent for 20X7 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 20X0.

The following were other significant assumptions used in the valuations as of December 31, 20X1 and 20X0.

Weighted-average discount rate	8.0%
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

NOTE 3: BENEFIT OBLIGATIONS

Health costs incurred by participants and their beneficiaries and dependents are covered by insurance contracts maintained by the Plan. It is the present intention of the Sponsor and the Plan to continue obtaining insurance coverage for benefits. As stated in note 1, the Sponsor is not permitted under present tax law to deduct amounts for future benefits (beyond one year). Insurance premiums for future years in respect of the Plan's postretirement benefit obligation will be funded by Sponsor contributions to the Plan in those later years.

The postretirement benefit obligation at December 31, 20X1 and 20X0, principally health benefits, relates to the following categories of participants (including their beneficiaries and dependents):

	20X1	*20X0*
Current retirees	$ 3,900,000	$3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Participants not yet fully eligible for benefits	5,000,000	4,165,000
	$11,000,000	$9,665,000

The health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the obligation as of December 31, 20X1 and 20X0, by $2,600,000 and $2,500,000, respectively.

NOTE 4: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 20X1, the plan's investments (including investments bought, sold, and held during the year) appreciated in value by $300,000, as follows:

	20X1		*20X0*
	Net Increase (Decrease) in Value During Year	*Fair Value at End of Year*	*Fair Value at End of Year*
Fair value as determined by quoted market price:			
U.S. government securities	$200,000	$5,000,000	$4,000,000
Corporate bonds and debentures	(25,000)	1,750,000	1,375,000
Common stocks	100,000	1,000,000	600,000
	275,000	7,750,000	5,975,000
Fair value as estimated by Classic Enterprise Benefits Plan Investment Committee:			
Corporate bonds	25,000	250,000	225,000
	$300,000	$8,000,000	$6,200,000

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets are as follows:

	20X1	*20X0*
Commonwealth Power Co., 9.0% bonds due 2014 ($500,000 face amount)	$475,000	$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 20X6 ($360,000 face amount)		350,000

NOTE 5: OTHER MATTERS

The Trust established under the Plan to hold the Plan's net assets is qualified pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the Trust's net investment income is exempt from income taxes. The Sponsor has obtained a favorable tax determination letter from the Internal Revenue Service and the Sponsor believes that the Trust, as amended, continues to qualify and to operate as designed.

NOTE 6: RECONCILIATION OF FINANCIAL STATEMENTS TO FORM 5500

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

	December 31,	
	20X1	*20X0*
Net assets available for benefits per the financial statements	$8,515,000	$6,600,000
Amounts due to insurance companies	1,200,000	1,000,000
Net assets available for benefits per the Form 5500	$7,315,000	$5,600,000

The following is a reconciliation of insurance premiums paid for participants per the financial statements to the Form 5500:

	Year ended December 31, 20X1
Insurance premiums paid per the financial statements	$16,815,000
Add: Amounts due insurance companies at December 31, 20X1	1,200,000
Less: Amounts due insurance companies at December 31, 20X0	(1,000,000)
Insurance premiums paid to participants per the Form 5500	$17,015,000

Exhibit F-9*

C&H Company Welfare Benefit Plan
Statement of Net Assets Available for Plan Benefits

	December 31, 20X1	December 31, 20X0
Assets		
Investments, at fair value:		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Net assets held in C&H Company defined benefit plan—restricted for 401(h) account (Notes A and E)	1,072,000	966,000
Receivables		
Employer contribution	500,000	430,000
Employee contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	110,000	115,000
Total assets	9,832,000	7,831,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
Total liabilities	275,000	265,000
Net assets available for plan benefits	$9,557,000	$7,566,000

The accompanying notes are an integral part of the financial statements.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

Exhibit F-10*

C&H Company Welfare Benefit Plan
Statement of Changes in Net Assets Available for Plan Benefits

	For the Year Ended December 31, 20X1
Additions	
Contributions	
Employer contributions	$15,000,000
Employee contributions	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
Total investment income	850,000
Less investment expense	15,000
Net investment income	835,000
Net increase in 401(h) account (Note E)	106,000
Total additions	18,941,000
Deductions	
Benefits paid directly to participants:	
Health care	16,000,000
Disability and death	770,000
Total benefits paid	16,770,000
Administrative expenses	180,000
Total deductions	16,950,000
Net increase during the year	1,991,000
Net assets available for benefits:	
Beginning of year	7,566,000
End of year	$ 9,557,000

The accompanying notes are an integral part of the financial statements.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

Exhibit F-11*

C&H Company Welfare Benefit Plan
Statement of Benefit Obligations

	For the Year Ended December 31, 20X1	*For the Year Ended December 31, 20X0*
Amounts currently payable to or for participants, beneficiaries, and dependents		
Health claims payable	$ 1,100,000	$ 975,000
Death and disability benefits payable	100,000	75,000
Total amounts currently payable	1,200,000	1,050,000
Other obligations for current benefit coverage, at present value of estimated amounts		
Claims incurred but not reported	425,000	390,000
Long-term disability benefits	925,000	610,000
Total other obligations for current benefit coverage	1,350,000	1,000,000
Total obligations other than postretirement benefit obligations	2,550,000	2,050,000
Postretirement benefit obligations		
Current retirees	3,900,000	3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Other participants not yet fully eligible for benefits	5,000,000	4,165,000
Total postretirement benefit obligations	11,000,000	9,665,000
Total benefit obligations	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

Exhibit F-12*

C&H Company Welfare Benefit Plan
Statement of Changes in Benefit Obligations

	For the Year Ended December 31, 20X1
Amounts currently payable to or for participants, beneficiaries, and dependents	
Balance, beginning of year	$ 1,050,000
Claims reported and approved for payment	16,930,000
Claims paid (including disability)	(16,770,000)
Claims paid through 401(h) account (Note E)	(10,000)
Balance, end of year	1,200,000
Other obligations for current benefit coverage, at present value of estimated amounts	
Balance, beginning of year	1,000,000
Net change during year:	
Long-term disability benefits	315,000
Other	35,000
Balance, end of year	1,350,000
Total obligations other than postretirement benefit obligations	2,550,000
Postretirement benefit obligations	
Balance, beginning of year	9,665,000
Increase (decrease) during the year attributable to:	
Benefits earned and other changes	1,250,000
Plan amendment	(175,000)
Changes in actuarial assumptions	260,000
Balance, end of year	11,000,000
Total benefit obligations, end of year	$13,550,000

The accompanying notes are an integral part of the financial statements.

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

Exhibit F-13*

C&H Company Welfare Benefit Plan
Notes to Financial Statements

NOTE A: 401(h) ACCOUNT

Effective January 1, 20X0, the [*Company's defined benefit pension plan*] was amended to include a medical-benefit component in addition to normal retirement benefits to fund a portion of the postretirement obligations for retirees and their beneficiaries in accordance with Section 401(h) of the Internal Revenue Code (IRC). A separate account has been established and maintained in the [*defined benefit pension plan*] for such contributions. In accordance with IRC Section 401(h), the Plan's investments in the 401(h) account may not be used for, or diverted to, any purpose other than providing health benefits for retirees and their beneficiaries. The related obligations for health benefits are not included in the [*defined benefit pension plan's*] obligations in the statement of accumulated plan benefits but are reported as obligations in the financial statements of the [*health and welfare benefit plan*].

NOTE E: 401(h) ACCOUNT

A portion of the Plan's obligations are funded through contributions to the Company's [*defined benefit pension plan*] in accordance with IRC Section 401(h). The following table presents the components of the net assets available for such obligations and the related changes in net assets available.

Net Assets Available for Postretirement Health and Welfare Benefits in 401(h) Account

	December 31,	
	20X1	*20X0*
Investments at fair value:		
U.S. government securities	$ 140,000	$150,000
Money market fund	900,000	800,000
	1,040,000	950,000
Cash	20,000	10,000
Employer's contribution receivable[106]	20,000	15,000
Accrued interest	7,000	6,000
Total assets	1,087,000	981,000
Accrued administrative expenses	(15,000)	(15,000)
Net assets available	$1,072,000	$966,000

* The illustrative financial statements example is from SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, which is effective for financial statements for plan years beginning after December 15, 1998 with earlier application encouraged.

[106] A receivable from the employer must meet the requirements of paragraph 10 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*.

Changes in Net Assets in 401(h) Account

	For the Year Ended December 31, 20X1
Net appreciation in fair value of investments:	
U.S. government securities	$ 10,800
Interest	80,200
	91,000
Employer contributions	40,000
Health and welfare benefits paid to retirees	(10,000)
Administrative expenses	(15,000)
Net increase in net assets available	$106,000

NOTE H: RECONCILIATION OF FINANCIAL STATEMENTS TO FORM 5500[107]

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

Net assets available for benefits per the financial statements	$ 9,557,000
Claims payable	(1,200,000)
Net assets held in defined benefit plan-401(h) account	(1,072,000)
Net assets available for benefits per Form 5500	$ 7,285,000

The following is a reconciliation of claims paid per the financial statements to the Form 5500:

Claims paid per the financial statements	$16,770,000
Add: Amounts payable at December 31, 20X1	1,200,000
Less: Amounts payable at December 31, 20X0	(1,050,000)
Claims paid per Form 5500	$16,920,000

[107] The reconciliation of amounts reported in plan financial statements to amounts reported in Form 5500 is required by ERISA.

Appendix G

Summary of Objectives, Procedures, and Other Considerations for Auditing Investments

G.01 This appendix summarizes the objectives, procedures, and other considerations for auditing plan investments discussed in chapter 7. Exhibit G-1 summarizes the objectives and procedures for auditing trusteed assets and assets invested in common/commingled and master trust funds. Exhibit G-2 summarizes the objectives and procedures for auditing plan assets held with an insurance contract.

G.02 This appendix is not intended to be all-inclusive or to suggest the specific objectives and procedures that should necessarily be adopted by an auditor of an employee benefit plan. Some of the illustrated objectives and procedures may not be relevant to a particular plan because of the type of plan or the absence of certain types of transactions or investments.

Exhibit G-1

	Paragraph References				
	Trusteed Assets		Types of Investments		
	Directed	Discretionary	Common/ Commingled	Master Trusts*	Mutual Funds
General Audit Objectives:					
Investments or units are recorded and exist	7.11(*a*)	7.11(*a*)	7.17(*a*)	7.11(*a*)	7.11(*a*)
Investments or units are owned by the plan and are unencumbered, or, if not, security interests are identified	7.11(*b*)	7.11(*b*)	7.17(*b*)	7.11(*b*)	7.11(*b*)
Investment or unit valuation is in accordance with generally accepted accounting principles (GAAP)	7.11(*c*)	7.11(*c*)	7.17(*c*)	7.11(*c*)	7.11(*c*)
Purchase, redemption, and income transactions of the investments or units are recorded in accordance with GAAP	7.11(*c*)	7.11(*c*)	7.17(*d*)	7.11(*c*)	7.11(*c*)
Investment presentation and disclosure is adequate	7.11(*d*)	7.11(*d*)	7.11(*d*)**	7.11(*d*)	7.11(*d*)
General Auditing Procedures:					
Obtain an understanding of the plan's investment strategy and the investments held by the plan	7.12(*a*)	7.14, 7.12(*a*)	7.16, 7.12(*a*)	7.12(*a*)	7.12(*a*), 7.19
Obtain an understanding of the plan's internal control relating to investments, in accordance with SAS No. 55, as amended by SAS No. 78	6.01, 7.13	6.01, 7.13	6.01, 7.18(*c*)	6.01	6.01, 7.20
Obtain single-audit reports (SAS No. 70 report) on trustee	6.07	6.07, 7.15	6.07, 7.18(*c*)	6.07	6.07, 7.20
Obtain an analysis of changes in investment portfolio	7.12(*b*)	7.14, 7.12(*b*)	7.18(*c*)	7.12(*b*)	7.12(*b*)
Obtain evidence of existence and ownership (i.e., confirmation or physical inspection)	7.12(*c*)	7.14, 7.12(*c*)	7.18(*a*)	7.12(*c*)	7.12(*c*), 7.20(*a*), 7.20(*c*)
Obtain an understanding of the trustee's responsibility and financial capability	7.12(*c*)	7.14, 7.12(*c*)	n/a	n/a	7.12(c)
Review minutes, agreements, and confirmations for security interests	7.12(*d*)	7.14, 7.12(*d*)	7.18(*b*)	7.12(*d*)	7.12(*d*)
Tests investment transactions (i.e., authorization, brokers advices, and computation of realized gains)	7.12(*e*)	n/a	7.18(*b*)	7.12(*e*)	7.20(*a*), 7.20(*b*)
Confirm securities in transit	7.12(*f*)	n/a	n/a	n/a	n/a
Test income accrual	7.12(*g*)	n/a	7.18(*c*)	7.12(*g*)	n/a
Test the computation of fair value	7.12(*h*)	7.14, 7.12(*h*)	n/a	n/a	7.20(*d*)
Test change in appreciation/depreciation	7.12(*i*)	n/a	7.18(*c*)	7.12(*i*)	7.12(*i*), 7.20(*e*)
Inquire regarding investments or transactions that violate laws or regulations	7.12(*j*)	7.14, 7.12(*j*)	7.18(*b*)	7.12(*j*)	7.12(*j*)
Obtain trust fund financial statements and agree units information	n/a	n/a	7.18(*c*)	7.24	7.20(*c*)

* The audit objectives and procedures described in paragraphs 7.11 and 7.12 also apply to the activities of a master trust pursuant to paragraph 7.23.

** Although this audit is not specifically listed in paragraphs 7.17, paragraph 7.11 lists audit objectives for all types of plan assets.

Exhibit G-2

	Paragraph References—Insurance Contracts					
	Deposit Administration	Immediate Participation Guarantee	Allocated Contracts	Guaranteed Investment Contract	Individual Separate Account	Pooled Separate Account
General Audit Objectives:						
Plan assets, represented by insurance contracts, exist	7.42(*a*)	7.31(*a*)	n/a	7.42(*a*)	7.42(*a*)	7.42(*a*)
Changes in plan assets are properly recorded and valued in accordance with generally accepted accounting principles	7.42(*b*)	7.42(*b*)	n/a	7.42(*b*)	7.42(*b*)	7.42(*b*)
No intention to dispose of or terminate contract	7.42(*c*)	7.42(*c*)	7.42(*c*)	7.42(*c*)	7.42(*c*)	7.42(*c*)
Compliance with contract terms and appropriate disclosure	7.42(*d*)	7.42(*d*)	7.42(*d*)	7.42(*d*)	7.42(*d*)	7.42(*d*)
General Auditing Procedures:						
Read the contract	7.43(*a*)	7.43(*a*)	7.43(*a*)	7.43(*a*)	7.43(*a*)	7.43(*a*)
Confirm the following:						
Contributions or premium payments made to the fund or account	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)
Interest, dividends, refunds, credits, and changes in value	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)
Contract value of the funds in the general account	7.43(*b*)*	7.43(*b*)*	n/a	7.43(*b*)	n/a	n/a
Fair value of the funds in the separate account	7.43(*b*)*	7.43(*b*)*	n/a	n/a	7.43(*b*)	7.43(*b*)
The amount of insurance company fee and other expenses	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)	7.43(*b*)
Annuity purchases or benefits paid from unallocated plan assets	7.43(*b*)	7.43(*b*)	n/a	n/a	7.43(*b*)	7.43(*b*)
Transfers between various funds and accounts	7.43(*b*)	7.43(*b*)	n/a	7.43(*b*)	7.43(*b*)	7.43(*b*)
Evaluate the reasonableness of interest credited to the contracts in relation to any minimum guaranteed interest rate stated in contract	7.44(*a*)	n/a	n/a	7.44(*a*)	n/a	n/a
Review the investment yield data furnished by the insurance company and compare the plan's investment return and changes in contract value	n/a	7.44(*b*)	n/a	n/a	n/a	n/a
Determine that annuity purchases were made pursuant to the rates stipulated in the contract	7.44(*c*)	n/a	n/a	n/a	n/a	n/a
Test benefits paid directly from the fund	7.44(*c*)	7.44(*c*)	n/a	n/a	7.44(*c*)**	7.44(*c*)**
Obtain an understanding of the insurance company's responsibility and financial capability	7.44(*d*)	7.44(*d*)	7.44(*d*)**	7.44(*d*)**	7.45	7.45
Test expenses charged to the contract	7.44(*e*)	7.44(*e*)	7.44(*e*)	n/a	7.44(*e*)**	7.44(*e*)**
Test investment or unit transactions	n/a	n/a	n/a	n/a	7.45(*a*)	7.45(*b*)
Obtain an understanding of the plan's internal control relating to investments, in accordance with SAS No. 55, as amended by SAS No. 78	6.01	6.01	6.01	6.01	6.01, 7.45	6.01,7.45
Obtain single-audit reports (SAS No. 70 report) on trustee	n/a	n/a	n/a	n/a	7.45(*a*)	7.45(*b*)
Obtain insurance company's financial statements and agree unit information	n/a	n/a	n/a	n/a	7.45(*a*)	7.45(*b*)

* For investment purposes, unallocated funds may be commingled in a general or pooled separate account or held in an individual separate account.

** The audit procedures discussed in the referenced paragraphs are also applicable to this type of insurance contract.

Appendix H

Appendix of Statement of Position 94-4: Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments

H.01 Fully benefit-responsive investment contracts held by defined-contribution plans, including both health and welfare, and pension plans that provide a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for participant-initiated liquidations, transfers, loans, or hardship withdrawals under the terms of the ongoing plan, should be reported at contract value, which may or may not be equal to fair value. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. Other investment contracts should generally be reported at fair value.

H.02 Investment contracts that do not provide a liquidity guarantee as discussed in paragraph H.01 may be valued by discounting the related cash flows based on current yields of similar investments with comparable durations. In determining the similarity of investments, appropriate consideration should be given to the credit quality of the contract issuer. Generally, contract termination (penalty) clauses need not be considered unless it is probable that the plan intends to terminate the contract.

H.03 In the following examples, value is determined within the context of the objectives of financial statements for a defined-contribution plan. The valuation must reflect the ability of the plan to pay benefits from the perspective of the participants. This value is then reflected on participants' statements to disclose the amount they can expect to receive when they exercise their rights to withdraw, borrow, or transfer funds under the terms of the plan.

EXAMPLE 1

A Five-Year Public Bond (or Portfolio of Bonds) Which Is Guaranteed by a Third Party to Have a Fixed Value at the End of Three Years

H.04 The guarantee applies only to the extent that the bond (or portfolio) is not liquidated prior to the end of three years. Liquidation within three years is at market value.

H.05 Because guaranteed proceeds from the bond are not available for benefit withdrawals or transfers prior to maturity, the contract should be valued at fair value. Fair value may be determined as the amount at which the bond could be exchanged in a current transaction between parties, other than in a forced or liquidation sale, considering the guaranteed fixed value of the bond at the end of three years.

EXAMPLE 2

A Benefit-Responsive Investment Contract

H.06 This contract provides a fixed crediting interest rate, and a financially responsible entity guarantees liquidity at contract value prior to maturity for any and all participant-initiated benefit withdrawals, loans, or transfers arising under the terms of the plan, which allows access for all participants on a quarterly basis.

H.07 The contract should be reported at contract value, because the plan will receive such value and only such value if the contract is accessed to pay participant benefits or transfers.

H.08 The contract described in the preceding paragraph would be viewed as fully benefit-responsive. Examples of some variations on this contract, and their impact on the valuation, follow.

a. *Liquidity at contract value is not guaranteed for benefits that are attributable to termination of the plan, a plan spin-off to a new employer plan, or amendments to plan provisions.* The contract should be reported at contract value unless it is probable that the plan will be terminated, spun off, or amended.

b. *Liquidity at contract value is not guaranteed for benefits that are attributable to the layoff of a large group of workers or an early retirement program.* The contract should be reported at contract value unless it is probable that termination of the employment of a significant number of employees will occur.

c. *The contract will pay for benefits of up to 30 percent of the contract at contract value, and any excess benefits will be at some adjusted value.* The contract should be reported at fair value. Fair value may be determined as the guaranteed amount plus the estimated discounted cash flows related to the amount in excess of 30 percent of the contract value.

d. *The contract will pay benefits at contract value, but only if the issuer of the contract determines that there is sufficient liquidity in the portfolio of assets that backs the contract.* Because the third party has not guaranteed liquidity for participant-initiated withdrawals, the contract should be reported at fair value.

e. *The contract will not pay benefits at contract value if benefits are due to participant transfers to another fixed income investment option, unless the funds are invested in an equity option for at least three months* (equity wash *provisions*). The contract should be reported at contract value.

EXAMPLE 3

A Five-Year, Nonbenefit-Responsive Investment Contract That Has No Liquid Market for Trading

H.09 The contract should be reported at fair value because there is no guarantee of liquidity at contract value. Fair value would be determined in the same manner as for an illiquid bond. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments,* includes a discussion of methods used to determine the fair values of illiquid instruments.

EXAMPLE 4

A Benefit-Responsive, Participating, Separate Account Investment Contract

H.10 A financially responsible issuer pays contract value for participant withdrawals, regardless of the value of the assets in the separate account. The credited interest rate is a function of the relationship between the contract value and the value of the assets in the separate account. The rate is reset periodically, daily, monthly, quarterly, and so on, by the issuer and cannot be less than zero. There may or may not be a specified maturity date on the contract. The contractholder may terminate the contract at any time, and receive the value of the assets in the separate account.

H.11 The contract should be reported at contract value because participants are guaranteed return of principal and accrued interest.

EXAMPLE 5

A Synthetic Investment Contract—"Managed" Type

H.12 This contract operates similarly to a separate account guaranteed investment contract (GIC), except that the assets are placed in a trust (with ownership by the plan) rather than a separate account of the issuer and a financially responsible third party issues a *wrapper* contract that provides that participants can, and must, execute plan transactions at contract value.

H.13 Inasmuch as trust assets are owned by the plan, the wrapper contract and the assets in trust should be separately valued and disclosed. The wrapper contract would be valued at the difference between the fair value of the trust assets and the contract value attributable by the wrapper to such assets. When considered together, the trust assets and the wrapper contract should be reported at the wrapper contract value because participants are guaranteed return of principal and accrued interest.

EXAMPLE 6

A Synthetic Investment Contract—"Repurchase" Type

H.14 Under this contract, the plan purchases a bond and places it in trust. The plan then contracts with a financially responsible third party to provide benefit responsiveness. Under the contract, should the bond need to be sold to meet a participant-initiated withdrawal benefit, loan, or transfer, the plan is obligated to sell the bond to the contract issuer, and the issuer is obligated to buy the bond. The transaction price is defined under the contract (for example, amortized cost). The issuer is not obligated, however, to purchase securities that are in default.

H.15 The contract, when considered together with the bond, should be reported at contract value (refer to paragraph H.13) absent impairment of the value of the securities due to credit risk because return of principal and accrued interest has been guaranteed to participants.

H.16 If the contract provided only an *option* for the sponsor to sell the bond to the issuer, rather than an obligation to do so, contract value would only apply when the fair value of the bond was less than contract value, because the option would then have value. Fair value may be determined as the greater of the estimated discounted cash flows or the option price.

Appendix I

Consideration of Fraud *

Introduction

I.01 Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit,* describes the auditor's responsibilities relating to fraud in a financial statement audit and provides guidance on what should be done to meet those responsibilities. There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Material misstatements arising from fraudulent financial reporting.
- Material misstatements arising from misappropriation of assets.

Misstatements arising from fraudulent financial reporting refer to intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involves the theft of a plan's assets that results in the financial statements not being presented in conformity with generally accepted accounting principles. Although fraud usually is concealed, the presence of risk factors or other conditions may alert the auditor to a possibility that fraud exists.

I.02 The risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped into the following categories.

- *Management's characteristics and influence over the control environment.* These pertain to plan management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
- *Industry conditions.* These involve the economic and regulatory environment in which the plan and its sponsor operates.
- *Operating characteristics and financial stability.* These pertain to the nature and complexity of a plan's operations and transactions, the plan's financial condition, and the changes in its assets available for benefits.

I.03 The risk factors that relate to misstatements arising from misappropriation of assets may be grouped into the following categories.

- *Susceptibility of assets to misappropriation.* These pertain to the nature of a plan's assets and the degree to which they are subject to theft.
- *Controls.* These involve the lack of controls designed to prevent or detect misappropriation of assets.

I.04 Fraud risk factors may be identified throughout the entire engagement process (for example, during client acceptance or continuance procedures, planning, fieldwork, or review). Other conditions, which may support or alter an auditor's judgment about the risk of material misstatement due to fraud, may be identified during audit fieldwork.

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* This appendix is based on material from the AICPA publication, *Consideration of Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82.*

I.05 The following table summarizes the fraud risk factors listed in SAS No. 82 and the auditor's related responsibilities.

SAS No. 82, Paragraph	*Description*	*Auditor's Responsibilities*
16 and 18	Broad categories of risk factors	The auditor should design the audit to assess risk within these risk factor categories or similar categories that embody the substance of those listed in SAS No. 82. If identified, they should be considered in the assessment of the risk of material misstatement due to fraud.
17 and 19	Detailed listing of example fraud risk factors	These are examples to illustrate the broad categories of risk factors described in paragraphs 16 and 18. Consideration should be given to tailoring these examples for the particular client. They usually are a subset of information normally gathered to perform an effective and efficient audit.
20	Information relating to employee relationships or pressures	The auditor is not required to plan the audit to detect these fraud risk factors. If the auditor becomes aware of the presence of these risk factors during the audit, they should be considered when making the assessment of the risk of material misstatement due to fraud.

Fraud Risk Factors

I.06 The following fraud risk factors and other conditions are intended to help auditors of employee benefit plans tailor the five broad risk factor categories defined in SAS No. 82. This list is intended to supplement the risk factors, other conditions, and related guidance found in the SAS. (It is a companion to but not a substitute for the guidance in the SAS.)

I.07 The presence of these example risk factors and other conditions identified during the engagement do not necessarily indicate the existence of fraud. When fraud risk factors or other conditions are found to be present during the engagement, professional judgment should be exercised when assessing their significance and relevance. As the auditor assesses the risk of material misstatement, it is important to keep in mind that the presence of a risk factor or condition should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances.

I.08 The Auditor Responses sections include procedures to consider when fraud risk factors and other conditions are present. Like the fraud risk factors and conditions, those procedures supplement the responses already described in SAS No. 82.

I.09 The following list should be used in conjunction with SAS No. 82 because not every example risk factor in paragraphs 17 and 19 of the SAS have been tailored, interpreted, or reprinted here and some of the example risk factors not reprinted may be applicable to the engagement.

Fraudulent Financial Reporting

A. Management Characteristics and Influence over the Control Environment

- *A motivation for management to engage in fraudulent financial reporting.*
  - Senior management of the plan sponsor appoints itself trustee of the plan and uses that position to benefit the plan sponsor, for example, uses the plan's money to do speculative investing or to support the company through buying employer assets or supporting a supplier.
- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - Failure by management to have adequate valuations performed, including actuarial valuations.
  - The plan administrator lacks an understanding of the major regulations that govern the plans (ERISA, or the Internal Revenue Code).
- Lack of management candor in dealing with plan participants, claimants, actuaries, and auditors regarding decisions that could have an impact on plan assets, including restructuring or downsizing arrangements.
- *Management displaying a significant disregard for regulatory authorities.*
  - Management displaying a significant disregard toward compliance with ERISA, Internal Revenue Code, and Department of Labor regulations.
  - The plan administrator or trustees have been investigated by the Department of Labor or IRS for fiduciary violations in operating the plan.
- The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL. (Such participation could be an indication of ineffective management of the plan or controls over the plan.)

B. Industry Conditions

- *Declining industry, with increasing business failures and significant declines in customer demand.*
  - The plan sponsor is in an industry that is declining in stability. This could lead to difficulties in meeting financial commitments to the plan, including contributions.
- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable.
- The plan has limited investment options or has invested significantly in employer assets other than employer securities.

C. Operating Characteristics and Financial Stability

- *Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*
  - Indications of significant or unusual parties-in-interest transactions not in the ordinary course of operations.
  - Excessive or unusual transactions with the plan sponsor/ administrator.

D. Auditor Responses

In addition to the sample responses presented in SAS No. 82, an auditor of an employee benefit plan may want to consider the following responses.

- *Investment Results.* Reconcile the information about investment position and activity obtained from the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor (the directing party) with investment information obtained directly from the plan trustee.
- *Claim Reserves.* Confirm with third parties the historical and statistical information used to prepare the reserves. Review the qualifications of the individuals preparing the reserves.
- Apply the following procedures to fully understand a party-in-interest transaction:
  - Confirm transaction amount and terms, including guarantees and other significant data, with the other party (or parties) to the transaction.
  - Inspect evidence that is in the possession of the other party or parties to the transaction.
  - Confirm significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
  - Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
  - With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.
- For single-employer plans, review the most recent financial statements of the plan sponsor for indicators of financial difficulties. For multi-employer plans, obtain an understanding of the industry.

Misappropriation of Assets

A. Susceptibility of Assets to Misappropriation

- A company sponsors multiple defined benefit pension plans; some underfunded, some overfunded.
- Lack of a qualified outside service provider to serve as trustee and/or custodian of plan assets.
- Nonreadily marketable, specialized or unique investments and management's lack of understanding of such investments. For example, derivative products such as futures, forwards, option and swap contracts, securities lending arrangements, junk bonds, real estate and specialized real estate investment securities, securities traded in non-U.S. markets, limited partnerships and real property.

B. Controls

- *Lack of appropriate management oversight.*
  - — Lack of review of plan investment transactions (e.g., by the trustee, sponsor, or the plan's investment committee).
  - — Lack of segregation of duties or independent checks.
  - — Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan.
- *Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans.*
  - — Plan administrator does not maintain independent records and periodically check information provided to the custodian.
- *Lack of appropriate system of authorization and approval of transactions.*
  - — Lack of approval of transactions with parties-in-interest that could lead to prohibited transactions.
- *Lack of timely and appropriate documentation for transactions.*
  - — Trustee does not prepare required supplemental information (e.g., historical cost records not maintained).
- Lack of controls over benefit payments, including the termination of payments in accordance with plan provisions.
- Lack of segregation of plan assets from the sponsor's assets or inappropriate access to plan assets by plan sponsor.
- SAS No. 70 report indicating a lack of adequate controls at an outside service provider.
- Use of a service provider that does not provide a SAS No. 70 report.
- Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recorded amounts for a defined contribution plan (unallocated assets or liabilities).

C. Auditor Responses

In addition to the sample responses presented in SAS No. 82, an auditor of an employee benefit plan may want to consider the following responses.

- Review reconciliations of the assets held by the trust with participant records throughout the year. Review any reconciling adjustments for propriety.
- Review the account activity for participants who have access to plan assets or assist in administering the plan.
- The auditor may have concluded that a risk of material misstatement exists due to a lack of a qualified outside service provider acting as trustee, custodian, or both for plan assets. In that situation, the auditor could physically inspect assets and examine other evidence relating to ownership. In addition, the fair value of investments could be tested by reference to market quotations or other evidence of fair value in accordance with SAS No. 57, *Auditing Accounting Estimates*.
- The auditor may have concluded that a risk of material misstatement exists because of unreconciled differences between net assets available for benefits per the trustee/custodian records and the recorded amounts for a defined contribution plan. If the trustee/custodian records are higher than the recorded amounts (excluding accrual adjustments), an unallocated asset exists that should be allocated to participant accounts. If assets per the trustee/custodian records are lower than the recorded amounts (excluding accrual adjustments), assets may have been misappropriated, requiring further investigation by the auditor (for example, reconciliation of monthly trustee/custodian activity to the record keeper).
- The auditor may have concluded that a risk of material misstatement exists with regard to remittance of employee contributions for a defined contribution plan because the sponsor is experiencing cash flow problems. In this instance, the auditor may perform a reconciliation of total employee contributions per the payroll register to the recorded amounts for the year, and may select certain months to test for the timely remittance of employee contributions in accordance with regulations.
- The auditor may have concluded that a risk of material misstatement exists because expenses of an underfunded plan are being paid by an overfunded plan. In this instance, the auditor might select expense amounts paid by the overfunded plan and trace them to specific invoices, noting that the expense was recorded by the appropriate plan. Alternatively, the auditor could review plan expenses paid by the plan's sponsor to make sure they were recorded on the appropriate plan.
- Review the timeliness of contributions from the plan sponsor throughout the year.
- Compare canceled checks to disbursement records. Where benefits are paid by check, compare the signature on the canceled check to participant signatures on other employee documents.
- Confirm benefit payments with participants or beneficiaries.
- Confirm medical bills directly with service providers.

I.10 An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances do not present a risk of material misstatement. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, auditors should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Appendix J

Statement of Position 99-2

Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans

July 28, 1999

Amendment to
AICPA Audit and Accounting Guide
Audits of Employee Benefit Plans

Issued by the
Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

TABLE OF CONTENTS

SUMMARY

This Statement of Position (SOP) would amend chapters 2 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide). This SOP specifies the accounting for and disclosure of 401(h) features of defined benefit pension plans, by both defined benefit pension plans and health and welfare benefit plans.

The SOP requires—

a. Defined benefit pension plans to record the aggregate amount of net assets held in a 401(h) account related to health and welfare plan obligations for retirees as both assets and liabilities on the face of the statement of net assets available for pension benefits in order to arrive at net assets available for pension benefits

b. 401(h) account assets used to fund health benefits, and the changes in those assets, to be reported in the financial statements of the health and welfare benefit plan. Benefit obligations related to the 401(h) account are also required to be reflected in the health and welfare plan financial statements

c. Defined benefit pension plans to disclose the fact that the 401(h) account assets are available only to pay retirees' health benefits

d. Health and welfare benefit plans to disclose in the notes to the financial statements the fact that retiree health benefits are funded partially through a 401(h) account of the defined benefit pension plan.

This SOP is effective for financial statements for plan years beginning after December 15, 1998. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively by restatement of financial statements for prior periods.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearing the FASB will propose suggestions, many of which are included in the documents.

Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans

Introduction

1. Some defined benefit pension plans provide a postretirement medical-benefit component in addition to the normal retirement benefits of the plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Employers may fund a portion of their postretirement medical-benefit obligations related to their health and welfare benefit plans through a health benefit account (401(h) account) in their defined benefit pension plans, subject to certain restrictions and limitations.

2. Funding can be accomplished through a qualified transfer of excess pension plan assets (as defined in Section 420 of the IRC) or through additional contributions to the 401(h) account by the employer, employees, or both. Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) must be used only to pay qualified current retiree health benefits for the taxable year of the transfer (whether directly or through reimbursement). Any assets transferred to the 401(h) account to pay retiree medical expenses in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used during the year must be transferred out of the account to the transferor plan and treated as an employer reversion for purposes of a 20 percent excise tax on reversions. The IRC allows employers to allocate up to 25 percent of total contributions to the plan, subject to certain limitations, to the 401(h) account. If the full amount of these contributions is not used during the year, they may be accumulated for future retiree medical expenses in the 401(h) account. The deductibility of employer contributions to a 401(h) account is subject to separate limitations and, therefore, such contributions have no effect on the amount of deductible contributions an employer can make to fund pension benefits under the plan. The earnings on the 401(h) account are ignored for minimum funding purposes. Additionally, under the IRC, qualified transfers are not treated as prohibited transactions for purposes of Section 4975.

3. The plan sponsor has discretion in making contributions to the 401(h) account. A pension or annuity plan may provide for payment of medical benefits for retired employees, their spouses, and their dependents if all of the following conditions are met.

a. Benefits are subordinate (as defined in section 401(h) of the IRC) to the retirement benefits provided by the plan.

b. A separate account is established and maintained for such benefits.

c. The employer's contributions to the separate account are reasonable and ascertainable.

d. It is impossible, at any time prior to the satisfaction of all obligations under the plan to provide such benefits, for any part of the corpus or income of the separate account to be (within the taxable year or thereafter) used for or diverted to any purpose other than the providing of such benefits.

e. Notwithstanding the provisions of certain IRC sections, upon satisfaction of all obligations under the plan to provide such benefits, any amount remaining in the separate account must, under the terms of the plan, be returned to the employer.

f. In the case of an employee who is a key employee, (as defined in Section 416(i)), a separate account is established and maintained for such benefits payable to such employee (and the spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are payable only to such employee (and the spouse and dependents) from that separate account.

4. The 401(h) assets may be used only to pay current retiree health benefits, which are obligations of a separate health and welfare benefit plan or health benefit arrangement. They may not be used to satisfy pension obligations. Although the assets may be invested together with assets that are available to pay pension benefits, a separate accounting must be maintained for all qualified transfers, contributions, distributions and/or expenses, and income earned thereon.

5. Financial Accounting Standards Board (FASB) Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, and the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) provide guidance to preparers and auditors of financial statements of defined benefit pension plans. Neither document addresses accounting for and reporting of 401(h) features of those plans.

Scope

6. Paragraphs 8 through 10 and paragraphs 13 and 14 of this SOP apply to all defined benefit pension plans that contain a 401(h) feature.

7. Paragraphs 11, 12, 15, and 16 of this SOP apply to health and welfare benefit plans if a portion or all of the benefits under such plans are funded through a 401(h) feature in a defined benefit pension plan.

Conclusions

Accounting and Reporting

Defined Benefit Pension Plans

8. Because the 401(h) net assets may not be used to satisfy pension obligations, the total of net assets available for pension benefits must not include assets held in the 401(h) account related to obligations of the health and welfare benefit plan. The 401(h) account assets less liabilities (net assets of the 401(h) account) are required to be shown in defined benefit pension plan financial statements as a single line item on the face of the statements (as illustrated in appendix B). Those net assets related to the 401(h) account also must be deducted before arriving at the total of net assets available for pension benefits. In deducting those net assets, the amount relating to 401(h) features should be presented as a separate line item in the liabilities section of the statement of net assets available for pension benefits. The financial statement

caption should clearly denote that the net assets held in the 401(h) account relate to obligations of the health and welfare plan or arrangement. The statement of changes in net assets should show only the changes in net assets of the pension plan and not any of the components of the changes in the net assets in the 401(h) account. The only amounts that should be reported in the statement of changes in net assets are qualified transfers to the 401(h) account and/or any unused or unspent amounts (including allocated income) in the 401(h) account at the end of the year that were qualified transfers of excess pension plan assets that should have been but were not transferred back to the defined benefit pension plan.

9. Information regarding accumulated plan benefits should relate only to pension obligations. Even in situations in which separate financial statements are not prepared for the health and welfare benefit plan, obligations related to retiree health benefits should not be reported in the statement of accumulated plan benefits of the defined benefit pension plan financial statements.

10. Illustrative financial statements for a defined benefit pension plan with a 401(h) feature are presented in appendix B.

Health and Welfare Benefit Plans

11. The 401(h) account assets used to fund health benefits, and the changes in those assets, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets and liabilities and changes in them can be shown in the health and welfare benefit plan financial statements in one of two ways. An entity can present that information either as a single line item on the face of the statements (as illustrated in appendix C) or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. If the assets and liabilities are shown as a single line item in the statement of net assets, the changes in net assets also should be shown as a single line item in the statement of changes in net assets. If the assets and liabilities are included in individual asset and liability line items in the statement of net assets, the changes in individual 401(h) amounts should be included in the changes in the individual line items in the statement of changes in net assets, with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. The 401(h) obligations are reported in the health and welfare benefit plan's statement of benefit obligations as required by SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. Likewise, the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account.

12. Illustrative financial statements of a health and welfare benefit plan funded through a 401(h) account in a separate defined benefit pension plan are presented in appendix C.

Disclosures

Defined Benefit Pension Plans

13. Defined benefit pension plans should disclose in the notes to the financial statements the nature of the assets related to the 401(h) account, and the fact that the assets are available only to pay retiree health benefits.

14. The Employee Retirement Income Security Act of 1974 (ERISA) requires that the 401(h) assets be reported as assets of the defined benefit pension plan in regulatory filings with the U.S. government. Paragraph 12.27 of the Guide notes that ERISA requires a plan's financial statements to include a note explaining differences between amounts reported in the financial statements and the amounts reported in the Form 5500 Annual Return/Report. Because ERISA requires 401(h) accounts to be reported as assets of the pension plan, a reconciliation of the net assets reported in the financial statements to those reported in Form 5500 is required. The reconciliation should be accompanied by a discussion of the 401(h) account, explaining clearly that the assets in the 401(h) account are not available to pay pension benefits.

Health and Welfare Benefit Plans

15. Health and welfare benefit plans should disclose in the notes to the financial statements the fact that retiree health benefits are funded partially through a 401(h) account of the defined benefit pension plan. Those plans also should disclose the fact that the assets in the 401(h) account are available only to pay retiree health benefits. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account.

16. As noted in paragraph 14 above, ERISA requires that the 401(h) assets be reported as assets of the defined benefit pension plan and not as assets of the health and welfare benefit plan in regulatory filings with the U.S. government. Paragraph 12.27 of the Guide notes that ERISA requires a plan's financial statements to include a note explaining differences between amounts reported in the financial statements and the amounts reported in the Form 5500. Because ERISA requires 401(h) accounts to be reported as assets of the pension plan, a reconciliation of the net assets reported in the financial statements to those reported in the Form 5500 is required for the health and welfare benefit plan.

Amendments to the Guide

17. The following is added to chapter 2, "Accounting and Reporting by Defined Benefit Pension Plans," of the Guide as paragraphs 2.36 through 2.44 under the section "Additional Financial Statement Disclosures." The existing Guide paragraphs 2.36 through 2.42 will be renumbered to paragraphs 2.43 through 2.51 as a result of these amendments.

> **2.36** *401(h) Accounts.* Some defined benefit pension plans provide a postretirement medical-benefit component in addition to the normal retirement benefits of the plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Employers may fund a portion of their postretirement medical-benefit obligations related to their health and welfare benefit plans through a health benefit account (401(h) account) in their defined benefit pension plans, subject to certain restrictions and limitations. Funding can be accomplished through a qualified transfer of excess pension plan assets or through additional contributions. Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) must be used only to pay qualified current retiree health benefits for the taxable year of the transfer (whether directly or through reimbursement). Any assets transferred to a 401(h) account

in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used in the year must be transferred out of the account to the pension plan.

2.37 The IRC allows employers to allocate up to 25 percent of total contributions to the plan, subject to certain limitations, to the 401(h) account. If the full amount of these contributions is not used during the year, they may be accumulated for future retiree medical expenses in the 401(h) account. The deductibility of employer contributions to a 401(h) account is subject to separate limitations and, therefore, such contributions have no effect on the amount of deductible contributions an employer can make to fund pension benefits under the plan. The earnings on the 401(h) account are ignored for minimum funding purposes. Additionally, under the IRC, qualified transfers are not treated as prohibited transactions for purposes of Section 4975.

2.38 The plan sponsor has discretion in making contributions to the 401(h) account. A pension or annuity plan may provide for payment of medical benefits for retired employees, their spouses, and their dependents if all of the following conditions are met.

a. Benefits are subordinate (as defined in Section 401(h) of the IRC) to the retirement benefits provided by the plan.

b. A separate account is established and maintained for such benefits.

c. The employer's contributions to the separate account are reasonable and ascertainable.

d. It is impossible, at any time prior to the satisfaction of all obligations under the plan to provide such benefits, for any part of the corpus or income of the separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits.

e. Notwithstanding the provisions of certain IRC sections, upon satisfaction of all obligations under the plan to provide such benefits, any amount remaining in the separate account must, under the terms of the plan, be returned to the employer.

f. In the case of an employee who is a key employee (as defined in Section 416(i)), a separate account is established and maintained for such benefits which are payable to such employee (and the spouse and dependents), and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are payable only to that employee (and the spouse and dependents) from the separate account.

2.39 The 401(h) assets may be used only to pay current retiree health benefits, which generally are obligations of a separate health and welfare benefit plan or health benefit arrangement. They may not be used to satisfy pension obligations. Although the assets may be invested together with assets that are available to pay pension benefits, a separate accounting must be maintained for all qualified transfers, contributions, distributions and/or expenses, and income earned thereon.

2.40 Because the 401(h) net assets may not be used to satisfy pension obligations, the total of net assets available for pension benefits must not include net assets held in the 401(h) account related to obligations of the health and welfare benefit plan. The 401(h) account assets less liabilities (net assets of the 401(h) account) are required to be shown in defined benefit pension plan financial statements as a single line item on the face of the statements (as illustrated in appendix B). Those net assets related to the 401(h) account also must be deducted before arriving at the total of net assets available for pension benefits. In deducting those net assets, the amount related to the 401(h) features should be presented as a separate line item in the liabilities section of the statement of net assets available for pension benefits. The financial statement caption should clearly denote that the net assets held in the 401(h) account relate to obligations of the health and welfare benefit plan or arrangement. The statement of changes in net assets should show only the changes in net assets of the pension plan and not any of the components of the changes in the net assets in the 401(h) account. The only amounts that should be reported in the statement of changes in net assets are qualified transfers to the 401(h) account and/or any unused or unspent amounts (including allocated income) in the 401(h) account at the end of the year that were qualified transfers of excess pension plan assets that should have been, but were not, transferred back to the defined benefit pension plan.

2.41 Information regarding accumulated plan benefits should relate only to pension obligations. Even in situations in which separate financial statements are not prepared for the health and welfare benefit plan, obligations related to retiree health benefits should not be reported in the statement of accumulated plan benefits of the defined benefit pension plan financial statements.

2.42 Defined benefit pension plans should disclose in the notes to the financial statements the fact that the 401(h) account assets are available only to pay retiree health benefits.

18. The following is added to chapter 4, "Accounting and Reporting by Health and Welfare Benefit Plans," of the Guide as paragraphs 4.54 and 4.55 under the section "Postretirement Benefit Obligations." The existing Guide paragraphs 4.54 through 4.55 are renumbered to paragraphs 4.56 through 4.57 as a result of these amendments.

4.54 Certain retiree health benefits may be funded through a 401(h) account in a defined benefit pension plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Refer to paragraphs 2.36 through 2.42 of this Guide for a detailed discussion of 401(h) accounts. The 401(h) account assets and liabilities used to fund retiree health benefits, and the changes in those assets and liabilities, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets used to fund health benefits, and the changes in those assets, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets and liabilities and changes in them can be shown in the health and welfare benefit plan financial statements in one of two ways. An entity can present that information either as a single line item on the face of the statements or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. If the assets and liabilities are shown as a single line item in the statement of net assets, the changes in net assets also should be shown as a single line item in the statement of changes in net assets. If the assets and liabilities are included in individual asset and liability line items in the statement of net assets, the changes in individual 401(h) amounts should be included in the changes in the individual line items in the statement of changes in net assets, with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. The 401(h) obligations are reported in the health and welfare benefit plan's statement of benefit obligations. Likewise, the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account.

4.55 If retiree health benefit obligations are funded partially through a 401(h) account of the defined benefit pension plan, the plan should also disclose the fact that the assets are available only to pay retiree health benefits. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. Additionally, the notes should include a reconciliation of amounts reported in the financial statements to the amounts reported in the Form 5500 (see paragraph 12.27).

19. The illustrative financial statements examples in appendix B of this SOP are added to the Guide as exhibits D-9 through D-11. The illustrative financial statements examples in appendix C of this SOP are added to the Guide as exhibits F-9 through F-13.

Effective Date and Transition

20. This SOP is effective for financial statements for plan years beginning after December 15, 1998. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively by restatement of financial statements for prior periods. If financial statements for prior periods are not presented, the financial statements for the year in which this SOP is first applied should disclose the effect of any restatement on the beginning balance of net assets.

APPENDIX A

Background Information and Basis for Conclusions

A.1. Practice in the area of accounting and reporting for 401(h) features of defined benefit pension plans was diverse. Some defined benefit pension plans reported all defined benefit and 401(h) account assets together in the statement of net assets available for benefits, and disclosed information about the 401(h) account in the notes to the defined benefit pension plan and health and welfare benefit plan financial statements. Others displayed the assets separately in multicolumnar format in the defined benefit pension plan financial statements, with note disclosures in the defined benefit plan and health and welfare benefit plan financial statements. The content of note disclosures varied significantly. Still others did not include the 401(h) assets in the defined benefit pension plan financial statements at all. Instead, the assets were reported in the financial statements of the related health and welfare benefit plan.

A.2. 401(h) account assets are used to pay benefits promised by a separate health and welfare benefit plan. Payments for retiree health benefits are made directly from the 401(h) account to the participant or his or her designee or as reimbursements to the sponsoring company. The pension plan basically is a funding vehicle for payment of those benefits. The AICPA Accounting Standards Executive Committees (AcSEC) believes the reporting of those 401(h) assets should be similar to financial statement reporting of separate accounts of life insurance companies, where the assets in the separate accounts are shown as a single line item described as "assets held in separate accounts." The same amount also is shown as a liability captioned "liabilities related to the separate accounts." The Industry Audit Guide *Audits of Stock Life Insurance Companies* states in the glossary that "separate accounts constitute a separate operation under which the assets fund the liabilities to variable annuity contractholders, pension funds, and others."

A.3. In substance, those 401(h) assets are assets of the health and welfare benefit plan because they will be used to pay retiree health benefits promised by that plan. Paragraph 25 of FASB Statement of Financial Accounting Concepts Statement No. 6, *Elements of Financial Statements*, defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." FASB Concepts Statement No. 6 further states in paragraph 172 that "Future economic benefit is the essence of an asset. An asset has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities."

A.4. This document was exposed for public comment for a period of ninety days. Some respondents to the exposure draft questioned the need for a detailed disclosure of 401(h) net assets in a defined benefit pension plans financial statements. The 401(h) assets legally are assets of the defined benefit pension plan. In addition, the Employee Retirement Income Security Act of 1974 (ERISA) requires that for regulatory filings with the U.S. government, 401(h) assets be reported in the financial statements of the defined benefit pension plan. Accordingly, AcSEC believes the legal status of the assets should be reflected in the defined benefit pension plan's statement of net assets available for benefits.

A.5. Because the 401(h) account assets are available only to pay retiree health and welfare benefits, it would be misleading to report them as assets in the statement of net assets available for plan benefits in a defined benefit pension plan without also reporting the same amounts as obligations in the liabilities section of the statement of net assets available for pension benefits. AcSEC also believes the net amount of 401(h) assets held in the pension plan should be included in the net assets of the health and welfare benefit plan and the changes in those net assets should be reflected in the statement of changes in net assets available for benefits, with note disclosure of the nature of the 401(h) account assets and activity.

A.6. Some respondents commented that the 401(h) account assets should only be displayed as a single line item on the face of the benefit plan's financial statements and not included in the individual asset and liability line items with a separate footnote disclosure. AcSEC considered two alternative presentations of the 401(h) account net assets in defined benefit pension plan financial statements—either single line item treatment on the face of the financial statements (single line presentation) or including the individual asset and liability line items with other defined benefit plan assets and liabilities and disclosing in the footnotes the 401(h) amounts included in those individual line items (broad presentation). Because those 401(h) assets are not available to defined benefit pension plan participants for the payment of benefits, AcSEC believes the broad presentation method may confuse the users of defined benefit pension plan financial statements. Therefore, AcSEC agreed to the single line presentation method of reporting 401(h) account assets and liabilities in defined benefit pension plan financial statements.

A.7. In health and welfare benefit plans, the proceeds from 401(h) account assets can be used only to pay retiree health and welfare benefits. They are not available to pay benefits for active employees. Legal title to such assets is held by the defined benefit pension plan. Therefore, some believe the single line presentation is most appropriate. Others believe such factors do not prevent the broad presentation which they believe is more useful. Because paragraph 11 of this SOP requires disclosure regarding the significant components of net assets and changes in net assets of the 401(h) account, AcSEC concluded it did not need to resolve this issue at this time and agreed to allow health and welfare benefit plans the option of reporting either the single line presentation or the broad presentation of the 401(h) account assets in the health and welfare benefit plan's financial statements.

APPENDIX B

Illustrative Defined Benefit Pension Plan Financial Statements and Related 401(h) Account Disclosures

B.1. This appendix illustrates certain applications of the provisions of this SOP that apply for the annual financial statements of a hypothetical defined benefit pension plan that has been amended to include a 401(h) account. It does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this illustration. It also does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

B.2. Although GAAP does not require comparative financial statements, Employee Retirement Income Security Act (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

B.3. ERISA and the Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP, and reported on by the independent auditor. See appendix A of *Audits of Employee Benefit Plans* for a further discussion of the ERISA and DOL requirements.

Example 1
C&H Company Pension Plan
Statement of Net Assets Available for Pension Benefits

	December 31, 20X1	December 31, 20X0
Assets		
Investments, at fair value (Note A):		
Plan interest in C&H Master Trust	$2,000,000	$1,660,000
C&H Company common stock	600,000	800,000
Investment contract with insurance company	850,000	800,000
Corporate bonds and debentures	3,000,000	3,170,000
U.S. government securities	300,000	200,000
Mortgages	480,000	460,000
Money market fund	270,000	240,000
Total investments	7,500,000	7,330,000
Net assets held in 401(h) account (Note H)	1,072,000	966,000
Receivables:		
Employer's contribution	20,000	10,000
Securities sold	310,000	175,000
Accrued interest and dividends	70,000	70,000
Total receivables	400,000	255,000
Cash	180,000	80,000
Total assets	9,152,000	8,631,000
Liabilities		
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	70,000	25,000
Amounts related to obligation of 401(h) account	1,072,000	966,000
Total liabilities	1,212,000	1,451,000
Net assets available for pension benefits	$7,940,000	$7,180,000

The accompanying notes are an integral part of the financial statements.

Example 2
C&H Company Pension Plan
Statement of Changes in Net Assets Available for Pension Benefits

	For the Year Ended December 31, 20X1
Investment income:	
Net appreciation in fair value of investments	$ 233,000
Interest	293,000
Dividends	4,000
	530,000
Less investment expenses	30,000
	500,000
Plan interest in C&H Master Trust investment income (Note F)	117,000
	617,000
Contributions (Note C):	
Employer	740,000
Employees	450,000
	1,190,000
Total additions	1,807,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	50,000
Total deductions	1,047,000
Net increase	760,000
Net assets available for pension benefits:	
Beginning of year	7,180,000
End of year	$7,940,000

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

A. 401 (h) Account

Effective January 1, 19X0, the Plan was amended to include a medical-benefit component in addition to the normal retirement benefits to fund a portion of the postretirement obligations for retirees and their beneficiaries in accordance with Section 401(h) of the Internal Revenue Code (IRC). A separate account has been established and maintained in the Plan for the net assets related to the medical-benefit component (401(h) account). In accordance with IRC Section 401(h), the Plan's investments in the 401(h) account may not be used for, or diverted to, any purpose other than providing health benefits for retirees and their beneficiaries. Any assets transferred to the 401(h) account from the defined benefit pension plan in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used during the plan year must be transferred out of the account to the pension plan. The related obligations for health benefits are not included in this Plan's obligations in the statement of accumulated plan benefits but are reflected as obligations in the financial statements of the health and welfare benefit plan. Plan participants do not contribute to the 401(h) account. Employer contributions or qualified transfers to the 401(h) account are determined annually and are at the discretion of the Plan Sponsor. Certain of the Plan's net assets are restricted to fund a portion of postretirement health benefits for retirees and their beneficiaries in accordance with IRC Section 401(h).

H. Reconciliation of Financial Statements to Form 5500[1]

The following is a reconciliation of net assets available for pension benefits per the financial statements to the Form 5500:

	December 31,	
	20X1	*20X0*
Net assets available for pension benefits per the financial statements	$7,940,000	$7,180,000
Net assets held in 401(h) account included as assets in Form 5500	1,072,000	966,000
Net assets available for benefits per the Form 5500	$9,012,000	$8,146,000

The net assets of the 401(h) account included in Form 5500 are not available to pay pension benefits but can be used only to pay retiree health benefits.

[1] The reconciliation of amounts reported in the plan's financial statements to amounts reported in Form 5500 is required by ERISA.

The following is a reconciliation of the changes in net assets per the financial statements to the Form 5500:

	For the Year Ended December 31, 20X1		
	Amounts per Financial Statements	*401(h) Account*	*Amounts per Form 5500*
Net appreciation in fair value of investments	$233,000	$10,800	$243,800
Interest income	293,000	80,200	373,200
Employer contributions	740,000	40,000	780,000
Benefits paid to retirees	740,000	10,000	750,000
Administrative expenses	50,000	15,000	65,000

APPENDIX C

Illustrative Health and Welfare Benefit Plan Financial Statements and Related 401(h) Account Disclosures—Single Line Presentation Approach

C.1. This appendix illustrates certain applications of the provisions of this SOP that apply to the financial statements of a health and welfare benefit plan that includes retiree health benefits that are funded partially through a 401(h) account in the plan sponsor's defined benefit pension plan. It illustrates the single line approach to presenting information about the 401(h) account permitted by paragraph 11 of this SOP. It does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this illustration. It also does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

C.2. Although GAAP does not require comparative financial statements, the Employee Retirement Income Security Act (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

C.3. ERISA and the Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP, and reported on by the independent auditor. See appendix A of *Audits of Employee Benefit Plans* for a further discussion of the ERISA and DOL requirements.

Example 1
C&H Company Welfare Benefit Plan
Statement of Net Assets Available for Plan Benefits

	December 31, 20X1	December 31, 20X0
Assets		
Investments, at fair value:		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Net assets held in C&H Company defined benefit plan—restricted for 401(h) account (Notes A and E)	1,072,000	966,000
Receivables		
Employer contribution	500,000	430,000
Employee contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	110,000	115,000
Total assets	9,832,000	7,831,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
Total liabilities	275,000	265,000
Net assets available for plan benefits	$9,557,000	$7,566,000

The accompanying notes are an integral part of the financial statements.

Example 2
C&H Company Welfare Benefit Plan
Statement of Changes in Net Assets Available for Plan Benefits

	For the Year Ended December 31, 20X1
Additions	
Contributions	
Employer contributions	$15,000,000
Employee contributions	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
Total investment income	850,000
Less investment expense	15,000
Net investment income	835,000
Net increase in 401(h) account (Note E)	106,000
Total additions	18,941,000
Deductions	
Benefits paid directly to participants:	
Health care	16,000,000
Disability and death	770,000
Total benefits paid	16,770,000
Administrative expenses	180,000
Total deductions	16,950,000
Net increase during the year	1,991,000
Net assets available for benefits:	
Beginning of year	7,566,000
End of year	$ 9,557,000

The accompanying notes are an integral part of the financial statements.

Example 3
C&H Welfare Benefit Plan
Statement of Benefit Obligations

	For the Year Ended December 31, 20X1	*For the Year Ended December 31, 20X0*
Amounts currently payable to or for participants, beneficiaries, and dependents		
Health claims payable	$ 1,100,000	$ 975,000
Death and disability benefits payable	100,000	75,000
Total amounts currently payable	1,200,000	1,050,000
Other obligations for current benefit coverage, at present value of estimated amounts		
Claims incurred but not reported	425,000	390,000
Long-term disability benefits	925,000	610,000
Total other obligations for current benefit coverage	1,350,000	1,000,000
Total obligations other than postretirement benefit obligations	2,550,000	2,050,000
Postretirement benefit obligations		
Current retirees	3,900,000	3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Other participants not yet fully eligible for benefits	5,000,000	4,165,000
Total postretirement benefit obligations	11,000,000	9,665,000
Total benefit obligations	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

Example 4
C&H Company Welfare Benefit Plan
Statement of Changes in Benefit Obligations

	For the Year Ended December 31, 20X1
Amounts currently payable to or for participants, beneficiaries, and dependents	
Balance, beginning of year	$ 1,050,000
Claims reported and approved for payment	16,930,000
Claims paid (including disability)	(16,770,000)
Claims paid through 401(h) account (Note E)	(10,000)
Balance, end of year	1,200,000
Other obligations for current benefit coverage, at present value of estimated amounts	
Balance, beginning of year	1,000,000
Net change during year:	
Long-term disability benefits	315,000
Other	35,000
Balance, end of year	1,350,000
Total obligations other than postretirement benefit obligations	2,550,000
Postretirement benefit obligations	
Balance, beginning of year	9,665,000
Increase (decrease) during the year attributable to:	
Benefits earned and other changes	1,250,000
Plan amendment	(175,000)
Changes in actuarial assumptions	260,000
Balance, end of year	11,000,000
Total benefit obligations, end of year	$13,550,000

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

A. 401(h) Account

Effective January 1, 19X0, the [*Company's defined benefit pension plan*] was amended to include a medical-benefit component in addition to normal retirement benefits to fund a portion of the postretirement obligations for retirees and their beneficiaries in accordance with Section 401(h) of the Internal Revenue Code (IRC). A separate account has been established and maintained in the [*defined benefit pension plan*] for such contributions. In accordance with IRC Section 401(h), the Plan's investments in the 401(h) account may not be used for, or diverted to, any purpose other than providing health benefits for retirees and their beneficiaries. The related obligations for health benefits are not included in the [*defined benefit pension plan's*] obligations in the statement of accumulated plan benefits but are reported as obligations in the financial statements of the [*health and welfare benefit plan*].

E. 401(h) Account

A portion of the Plan's obligations are funded through contributions to the Company's [*defined benefit pension plan*] in accordance with IRC Section 401(h). The following table presents the components of the net assets available for such obligations and the related changes in net assets available.

Net Assets Available for Postretirement Health and Welfare Benefits in 401(h) Account

	December 31,	
	20X1	*20X0*
Investments at fair value:		
U.S. government securities	$ 14,000	$150,000
Money market fund	900,000	800,000
	1,040,000	950,000
Cash	20,000	10,000
Employer's contribution receivable[2]	20,000	15,000
Accrued interest	7,000	6,000
Total assets	1,087,000	981,000
Accrued administrative expenses	(15,000)	(15,000)
Net assets available	$1,072,000	$966,000

[2] A receivable from the employer must meet the requirements of paragraph 10 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*.

Changes in Net Assets in 401(h) Account

	For the Year Ended December 31, 20X1
Net appreciation in fair value of investments:	
U.S. government securities	$ 10,800
Interest	80,200
	91,000
Employer contributions	40,000
Health and welfare benefits paid to retirees	(10,000)
Administrative expenses	(15,000)
Net increase in net assets available	$106,000

H. Reconciliation of Financial Statements to Form 5500[3]

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

Net assets available for benefits per the financial statements	$ 9,557,000
Claims payable	(1,200,000)
Net assets held in defined benefit plan-401(h) account	(1,072,000)
Net assets available for benefits per Form 5500	$ 7,285,000

The following is a reconciliation of claims paid per the financial statements to the Form 5500:

Claims paid per the financial statements	$16,770,000
Add: Amounts payable at December 31, 20X1	1,200,000
Less: Amounts payable at December 31, 20X0	(1,050,000)
Claims paid per Form 5500	$16,920,000
Net investment income per the financial statements	$ 835,000
Less: Net investment income related to the changes in the investments of the 401(h) assets	91,000
Net investment income per Form 5500	$ 744,000

[3] The reconciliation of amounts reported in plan financial statements to amounts reported in Form 5500 is required by ERISA.

Appendix K

Statement of Position 99-3

Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters

September 15, 1999

Amendment to
AICPA Audit and Accounting Guide
Audits of Employee Benefit Plans

Issued by the
Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

TABLE OF CONTENTS

SUMMARY

This Statement of Position (SOP) amends chapters 3 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide). This SOP amends SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Plans*, and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. This SOP simplifies disclosures for certain investments and supersedes AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans*.

This SOP—

- Amends paragraph 3.20 of the Guide to eliminate the previous requirement for a defined contribution plan to present plan investments by general type for participant-directed investments in the statement of net assets available for benefits.
- Amends paragraph 3.28(*k*) and supersedes paragraph 3.28(*l*) of the Guide and supersedes Practice Bulletin 12 to eliminate the requirement for a defined contribution plan to disclose participant-directed investment programs and to eliminate the requirement to disclose the total number of units and the net asset value per unit during the period, and at the end of the period, by defined contribution pension plans that assign units to participants.
- Amends paragraph 3.28(*g*) of the Guide to require a defined contribution plan to identify nonparticipant-directed investments that represent 5 percent or more of net assets available for benefits.
- Amends paragraphs 3.28(*p*) and 4.57 of the Guide, paragraph 53 of SOP 92-6, and paragraph 15 of SOP 94-4 to eliminate the requirement for defined contribution plans, including both health and welfare benefit plans and pension plans, to disclose benefit-responsive investment contracts by investment fund option.
- Replaces exhibits E-1 through E-5 in the Guide.

This SOP is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by-fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, the clearance of the proposed project and proposed documents by the FASB reflect suggested changes to the proposed items.

Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters

Introduction

1. The primary objective of a **defined contribution plan's**[1] financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits. This objective is consistent with the objectives of a pension plan's financial statements as stated in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. The primary users of a defined contribution plan's financial statements are the plan sponsor(s), plan participants, and the following governmental regulators: the U.S. Department of Labor (DOL), the Internal Revenue Service (IRS), and the Securities and Exchange Commission (SEC). For employee benefit plans that are subject to the Employee Retirement Income Security Act (ERISA), many of the disclosures in a plan's financial statements are provided in order to comply with certain regulatory requirements. For substantially all plans, the financial statement information is reported to the regulatory agencies on Form 5500, Annual Return/Report of Employee Benefit Plans, which includes financial statements and supplemental schedules (for example, plan investments and reportable transactions).

2. Paragraph 3.28(*k*) of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) established requirements for separately reporting information about participant-directed **investment fund options** within defined contribution plans. AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans*, clarified the reporting requirements set forth in paragraph 3.28(*k*). Plans that provide participant-directed investment programs were required to disclose amounts relating to each such program as a separate fund, either in columnar form in the financial statements or in the related disclosures, or through separate financial statements for each investment fund option.

3. Statement of Position (SOP) 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Plans*, paragraph 15; paragraphs 3.28(*p*) and 4.57 of the Guide; and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* (SOP 92-6, as amended by SOP 94-4[2]), paragraph 53, required defined contribution pension and **health and welfare benefit plans** to disclose the following information relating to **benefit-responsive investment contracts** in the aggregate by investment fund option:

- The average yield for each period for which a statement of net assets available for benefits is presented
- The crediting interest rate as of the date of each statement of net assets available for benefits presented

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[1] Terms defined in the glossary are set in boldface type the first time they appear in this SOP.

[2] The original paragraph 53 of SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, has been renumbered to paragraph 58 by the issuance of SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*. The amended SOP can be found in the AICPA *Technical Practice Aids*, sec. 10,530.

- The amount of valuation reserves recorded to adjust contract amounts
- The fair values of benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended

4. Paragraph 3.28(*l*) of the Guide required defined contribution pension plans that assign units to participants to disclose "the total number of units and the net asset value per unit during the period (for example, monthly or quarterly, depending on the plan's provisions for calculating the unit values) and at the end of the period."

5. Paragraph 3.20 of the Guide required defined contribution plans to present plan investments in the statement of net assets available for benefits by general type.

6. Paragraph 3.28(*g*) of the Guide requires identification of investments that represent 5 percent or more of the net assets available for benefits.

Scope

7. Paragraphs 8 through 12 of this SOP apply to all defined contribution plans with participant-directed investment programs. Paragraphs 13 and 14 of this SOP apply to all defined contribution health and welfare benefit plans with benefit-responsive investment contracts.

Conclusions

Defined Contribution Plans

Presentation in Defined Contribution Plan Financial Statements of Information About Investments, Participant-Directed Investment Programs, and Units of Participation

8. A defined contribution plan that provides participant-directed investment programs is no longer required to disclose amounts relating to those individual programs as a separate fund in the financial statements in columnar form, or in the related disclosures, or by separate financial statements for each program as required by Practice Bulletin 12. However, if a defined contribution plan provides for both participant-directed and nonparticipant-directed[3] investment programs, the plan should disclose information in the financial statements about the net assets and significant components of the changes in net assets relating to the nonparticipant-directed program with such reasonable detail, either in the financial statements or the accompanying notes, as is necessary to identify the types of investments and changes therein.

9. Defined contribution plans are not required to present participant-directed plan investments in the statement of net assets available for benefits by general type as required by paragraph 3.20 of the Guide. Participant-directed

[3] If a plan offers a program that is both participant- and nonparticipant-directed, and if the participant-directed and nonparticipant-directed amounts cannot be separately determined, the plan will be deemed to be nonparticipant-directed for purposes of this disclosure. For example, an employer-sponsored plan offers six investment fund options, one of which is a stock fund that includes only the employer's stock. Employees at their discretion may invest their contributions in any or all of the six options. However, the employer's contribution to the plan (for example, the company match) is automatically invested in the employer's stock fund. The stock fund is considered to be nonparticipant-directed for purposes of this disclosure if the employee and the employer amounts cannot be separately determined.

plan investments may be shown in the aggregate, as a one-line item, in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investment companies (also known as mutual funds), government securities, short-term securities, corporate bonds, common stocks, mortgages, loans to participants, and real estate. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise.

10. In addition to the current requirement to identify those investments that represent 5 percent or more of net assets available for benefits, defined contribution plans should specifically identify those investments that represent 5 percent or more of net assets available for benefits that are nonparticipant-directed.

11. Defined contribution plans no longer need to disclose, by investment fund option, the information on benefit-responsive investment contracts as required by paragraph 15 of SOP 94-4, paragraphs 3.28(*p*) and 4.57 of the Guide, and paragraph 53[4] of SOP 92-6. However, the disclosures set forth in SOP 94-4, paragraph 15; the Guide, paragraphs 3.28(*p*) and 4.57 (bullet 17); and SOP 92-6, paragraph 53 (as amended by SOP 94-4[4]), are still required in the aggregate.

12. Defined contribution plans (participant-directed and nonparticipant-directed) that assign units to participants are not required to disclose the total number of units and the net asset value per unit during the period, and at the end of the period as required by Guide paragraph 3.28(*l*).

Defined Contribution Health and Welfare Benefit Plans

13. Defined contribution health and welfare benefit plans no longer need to disclose the information on benefit-responsive investment contracts by investment fund option, as required by paragraph 15 of SOP 94-4, paragraphs 3.28(*p*) and 4.57 of the Guide, and paragraph 53[4] of SOP 92-6. However, the disclosures set forth in SOP 94-4, paragraph 15; the Guide, paragraphs 3.28(*p*) and 4.57 (bullet 17); and SOP 92-6, paragraph 53 (as amended by SOP 94-4[4]), are still required in the aggregate.

14. In addition to the disclosures listed in paragraph 13, defined contribution health and welfare benefit plans should specifically identify those investments that represent 5 percent or more of net assets available for benefits.

Amendments to the Guide

15. In paragraph 3.09 and footnote 6, the phrase "when they are due" is deleted.

16. In paragraphs 3.11 and 4.20, the phrase "when due" is deleted.

17. Paragraph 3.20 is replaced with the following.

Participant-directed plan investments may be shown in the aggregate, as a one-line item, in the statement of net assets available for benefits.

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[4] The original paragraph 53 of SOP 92-6 has been renumbered to paragraph 58 by the issuance of SOP 94-4. The amended SOP can be found in the AICPA *Technical Practice Aids*, sec. 10,530.

The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investment companies (also known as mutual funds), government securities, short-term securities, corporate bonds, common stocks, mortgages, loans to participants, and real estate. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise.

18. In paragraph 3.28(*g*), the following is added after the first sentence:

If any of those investments are nonparticipant-directed, they should be identified as such.

19. Paragraph 3.28(*k*) is replaced with the following:

If a defined contribution plan provides for participant-directed and nonparticipant-directed investment programs, the plan should disclose information in the financial statements about the net assets and significant components of the changes in net assets relating to the nonparticipant-directed program with such reasonable detail, either in the financial statements or accompanying notes, as is necessary to identify the types of investments and changes therein.

A plan provides for participant-directed investment programs if it allows participants to choose among various investment alternatives. The available alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, that provide varying kinds of investments—for example, equity funds and fixed income funds. The participant may select among the various available alternatives and periodically change that selection.

20. Paragraph 3.28(*l*) is eliminated.

21. In paragraph 3.28(*p*), the phrase "by investment option" is deleted.

22. In the seventeenth bullet of paragraph 4.57, the phrase "by investment option" is deleted.

23. Exhibits E-1 through E-5 in the Guide are superseded by the illustrative financial statements and disclosures in appendix B of this SOP.

24. The terms "benefit-responsive investment contract" and "investment fund option," as defined in the glossary of this SOP, are added to the glossary of the Guide.

Amendments to SOP 94-4

25. In paragraph 15, the phrase "by investment option" is deleted.

26. In paragraph 17(*g*)(*o*), the phrase "by investment option" is deleted.

27. In paragraph 17(*l*)(*i*), the phrase "by investment option" is deleted.

28. In the first bullet of paragraph 18(*e*), the phrase "by investment option" is deleted.

Amendment to SOP 92-6

29. In the sixteenth bullet of paragraph 53[5] (which was added by SOP 94-4), the phrase "by investment option" is deleted.

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[5] The original paragraph 53 of SOP 92-6 has been renumbered to paragraph 58 by the issuance of SOP 94-4. The amended SOP can be found in the AICPA *Technical Practice Aids*, sec. 10,530.

Practice Bulletin 12

30. This SOP supersedes AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans.*

Effective Date and Transition

31. This SOP is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by-fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

APPENDIX A

Background Information and Basis for Conclusions

A.1. The Accounting Standards Executive Committee (AcSEC) considered whether the disclosures required by paragraph 3.28(*k*) of the Guide should be made by a defined contribution plan for its participant-directed investment programs. Paragraph 3.28(*k*) of the Guide, as clarified by Practice Bulletin 12, required all plans that provide participant-directed investment fund options to disclose the options separately and show in the financial statements amounts relating to each individual investment fund option, either in columnar format on the face of the financial statements, in the related notes to the financial statements, or in separate financial statements for each option. Practice Bulletin 12 clarified that paragraph 3.28(*k*) requires plans to disclose information about the net assets and significant components of changes in net assets for each participant-directed investment fund option.

A.2. Since the issuance of Practice Bulletin 12, there has been an increase in the number of investment programs offered to participants of defined contribution plans. At the same time, financial information about many investment fund options has become widely available, often with more frequency than the issuance of plan financial statements. For example, certain daily business publications and information services, such as Bloomberg Pricing Service and Interactive Data Corporation, provide financial information about investment fund options. In addition, financial information is publicly available for many investment fund options throughout the year, including upon request from fund distributors and the Securities and Exchange Commission (SEC). In each instance, participants and other interested parties are provided with financial information that is similar in many respects to the information required to be disclosed under paragraph 3.28(*k*) of the Guide. In addition, plan participants receive information about the plan in the form of at least annual (often quarterly) individual single-employer account statements and summary annual reports. Also, plan administrators and the trustees regularly provide plan participants with information on the investment fund options, such as prospectuses on mutual funds, or provide copies of the individual account statements on a quarterly basis.

A.3. The primary objective of a defined contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits. That objective is fulfilled, in part, when the plan's financial statements provide information that is relevant and timely and the benefit of doing so justifies the cost. In view of the fact that plan participants now have available from other sources financial information about many participant-directed investment fund options, in many cases more timely and frequently than plan financial statements (for example, daily valuations), AcSEC believes that the benefit of plans presenting certain disclosures required by Guide paragraphs 3.28(*k*) and 3.28(*l*) for defined contribution plans is diminished. Furthermore, the periodic per unit net asset value disclosure is not a meaningful disclosure in the current plan investment environment because of the increased frequency of measuring unit values (that is, daily valuations), and plan participants generally receive more timely investment information from their individual participant statements. AcSEC believes that continuing to require those disclosures under these circumstances would impose an increasing compliance burden on plans, the cost of which would grow increasingly difficult to justify as more investment programs are offered to participants. Consequently, AcSEC has concluded that certain disclosures required by paragraphs 3.28(*k*) and 3.28(*l*) should not be required for defined contribution plans. Paragraph 3.28(*k*) is amended to reflect this conclusion and to reflect certain other disclosure requirements carried forward from Practice Bulletin 12, which is superseded by this SOP. Paragraph 3.28(*l*) is eliminated from the Guide.

A.4. The U. S. Department of Labor (DOL) is a primary user of a defined contribution plan's financial statements, and many of the disclosures in a plan's financial statements are provided in order to comply with certain regulatory requirements. Although this SOP eliminates the Guide paragraph 3.28(*k*) requirement to disclose amounts relating to individual participant-directed investment programs, it still requires that information about nonparticipant-directed investment programs in the aggregate be disclosed. This SOP also amends paragraph 3.20 of the Guide to require a defined contribution plan to present in the financial statements or accompanying notes plan investments by general type for only nonparticipant-directed investments. In addition, this SOP adds to the existing Guide paragraph 3.28(*g*) requirements to identify those investments that represent 5 percent or more of net assets available for benefits that are nonparticipant-directed. The DOL has advised that disclosure of information about nonparticipant-directed investment programs in the aggregate is useful in its regulation of defined contribution plans. In addition, AcSEC believes disclosure of such information is useful in providing information about plan resources and how the plan trustee's stewardship responsibility for those resources has been discharged.

A.5. SOP 94-4, paragraph 15, and the Guide, paragraphs 3.28(*p*) and 4.57, required defined contribution plans to disclose certain aggregate information about benefit-responsive investment contracts by investment option. Furthermore, SOP 94-4, paragraph 15; the Guide, paragraph 4.57; and SOP 92-6, paragraph 53 (as amended by SOP 94-4), required defined contribution health and welfare plans to disclose certain aggregate information about fully benefit-responsive investment contracts by investment option. AcSEC believes that disclosure of this information by investment option should not be required, and elimination of this disclosure is consistent with the elimination of certain Guide paragraph 3.28(*k*) disclosures. However, disclosure of this information in the aggregate is still required. Consequently, SOP 94-4, paragraph 15; paragraphs 3.28(*p*) and 4.57 of the Guide; and SOP 92-6, paragraph 53, are amended.

A.6. This document was exposed for public comment for a period of sixty days. Certain respondents to the exposure draft believed that paragraph 3.20 of the Guide should not be amended. Paragraph 3.20 of the Guide required defined contribution plans to present plan investments detailed by general type in the statement of net assets available for benefits. AcSEC believes including participant-directed investments by general type in the financial statements for a defined contribution plan does not provide useful information in assessing the plan's present and future ability to pay benefits, nor does AcSEC believe it provides useful information to evaluate the trustee's stewardship responsibilities over those assets. Consequently, AcSEC has concluded that a defined contribution plan may present participant-directed plan investments in the aggregate, as a one-line item, on the statement of net assets available for benefits without detailing them by general type.[6] In addition, as mentioned in paragraph A.4, AcSEC believes the disclosure of nonparticipant-directed investment information by general type is useful in providing information about plan resources and how the plan trustee's stewardship responsibility for those resources has been discharged.

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[6] Form 5500, item 31, requires investments to be detailed by general type.

A.7. AcSEC decided to permit, but not require, early application of this SOP in plan financial statements for a fiscal year for which annual financial statements have not been issued. AcSEC believes that requiring entities that may adopt the SOP early to reclassify amounts in the financial statements when by-fund disclosures are eliminated will improve comparability.

APPENDIX B

Illustrative Financial Statements and Disclosures of a Defined Contribution Plan With Participant-Directed and Nonparticipant-Directed Investment Programs

B.1. This Appendix illustrates certain applications of the provisions of this SOP that apply to the annual financial statements of a defined contribution plan with participant-directed and nonparticipant-directed investments. These illustrative financial statements and disclosures supersede exhibits E-1 through E-5 in the Guide.

XYZ Company 401(k) Plan
Statements of Net Assets Available for Benefits

	December 31,	
	20X1	*20X0*
Assets:		
Investments (See Note C)	$9,177,000	$7,995,000
Receivables:		
Employer contribution	14,000	10,000
Participant contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,243,000	8,055,000
Liabilities:		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits	$9,218,000	$8,035,000

See accompanying notes to the financial statements.

XYZ Company 401(k) Plan
Statement of Changes in Net Assets Available for Benefits

	Year Ended December 31, 20X1
Additions:	
Additions to net assets attributed to:	
Investment income:	
Net appreciation in fair value of investments (see Note C)	$ 279,000
Interest	439,000
Dividends	165,000
	883,000
Less investment expenses	(50,000)
	833,000
Contributions:	
Participant	900,000
Employer	699,000
	1,599,000
Total additions	2,432,000
Deductions:	
Deductions from net assets attributed to:	
Benefits paid to participants	1,144,000
Administrative expenses (see Note F)	105,000
Total deductions	1,249,000
Net increase	1,183,000
Net assets available for benefits:	
Beginning of year	8,035,000
End of year	$9,218,000

See accompanying notes to the financial statements.

Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company ("Company") 401(k) Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act (ERISA).

2. *Contributions.* Each year, participants may contribute up to 12 percent of pretax annual compensation, as defined in the Plan. Participants may also contribute amounts representing distributions from other qualified defined benefit or defined contribution plans. Participants direct the investment of their contributions into various investment options offered by the Plan. The Plan currently offers two mutual funds and an insurance investment contract as investment options for participants. The Company contributes 25 percent of the first 6 percent of base compensation that a participant contributes to the Plan. The matching Company contribution is invested directly in XYZ Company common stock. Additional profit sharing amounts may be contributed at the option of the Company's board of directors and are invested in a portfolio of investments as directed by the Company. Contributions are subject to certain limitations.

3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and allocations of (*a*) the Company's contribution and (*b*) Plan earnings, and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.

4. *Vesting.* Participants are vested immediately in their contributions plus actual earnings thereon. Vesting in the Company's contribution portion of their accounts is based on years of continuous service. A participant is 100 percent vested after five years of credited service.

5. *Participant Loans.* Participants may borrow from their fund accounts a minimum of $1,000 up to a maximum of $50,000 or 50 percent of their account balance, whichever is less. The loans are secured by the balance in the participant's account and bear interest at rates that range from 6 percent to 10 percent, which are commensurate with local prevailing rates as determined quarterly by the Plan administrator.

6. *Payment of Benefits.* On termination of service due to death, disability, or retirement, a participant may elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or annual installments over a ten-year period. For termination of service for other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

B. Summary of Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Investment Valuation and Income Recognition

The Plan's investments are stated at fair value except for its benefit-responsive investment contract, which is valued at contract value (Note E). Quoted market prices are used to value investments. Shares of mutual funds are valued at the net asset value of shares held by the Plan at year end.

Purchases and sales of securities are recorded on a trade-date basis. Dividends are recorded on the ex-dividend date.

C. Investments

The following presents investments that represent 5 percent or more of the Plan's net assets.

	December 31,	
	20X1	*20X0*
XYZ Company common stock, 400,000 and 390,000 shares, respectively	$ 470,000*	$ 420,000*
ABC Corporation common stock, 390,000 and 380,000 shares, respectively	490,000*	450,000*
Prosperity Investments Common Stock Fund, 226,250 and 200,000 shares, respectively	2,262,500*	2,000,000*
Prosperity Investments Balanced Fund, 40,000 and 210,000 shares, respectively	1,422,000	2,100,000
Investment Contract with National Insurance Company, #2012A, matures 12/31/X5 (Note E)	1,500,000	650,000

* Nonparticipant-directed

During 20X1, the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated in value by $279,000 as follows:

Mutual funds	$229,000
Common stock	30,000
Corporate bond	30,000
U.S. Government Securities	(10,000)
	$279,000

D. Nonparticipant-Directed Investments

Information about the net assets and the significant components of the changes in net assets relating to the nonparticipant-directed investments is as follows:

	December 31, 20X1	December 31, 20X0
Net Assets:		
Common stock	$ 960,000	$ 870,000
Mutual funds	2,262,500	2,000,000
Corporate bonds	307,500	255,000
U.S. Government Securities	225,000	120,000
	$3,755,000	$3,245,000

	Year Ended December 31, 20X1
Changes in Net Assets:	
Contributions	$ 699,000
Dividends	165,000
Net appreciation	60,000
Benefits paid to participants	(280,000)
Transfers to participant-directed investments	(134,000)
	$ 510,000

E. Investment Contract with Insurance Company

In 20X0, the Plan entered into a benefit-responsive investment contract with National Insurance Company (National). National maintains the contributions in a general account. The account is credited with earnings on the underlying investments and charged for participant withdrawals and administrative expenses. The contract is included in the financial statements at contract value as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less participant withdrawals and administrative expenses. Participants may ordinarily direct the withdrawal or transfer of all or a portion of their investment at contract value.

There are no reserves against contract value for credit risk of the contract issuer or otherwise. The average yield and crediting interest rates were approximately 8 percent for 20X1 and 20X0. The crediting interest rate is based on a formula agreed upon with the issuer, but may not be less than 4 percent. Such interest rates are reviewed on a quarterly basis for resetting.

F. Related-Party Transactions

Certain Plan investments are shares of mutual funds managed by Prosperity Investments. Prosperity Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest transactions. Fees paid by the Plan for the investment management services amounted to $105,000 for the year ended December 31, 20X1.

G. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants would become 100 percent vested in their employer contributions.

H. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated August 30, 1986, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). Although the Plan has been amended since receiving the determination letter, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Glossary

Defined contribution plan. A plan that provides an individual account for each participant and provides benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience, and (*c*) any forfeitures allocated to the account, less any administrative expenses charged to the plan.

Benefit-responsive investment contract. A contract between an insurance company, a bank, a financial institution, or any financially responsible entity and a plan that provides for a stated return on principal invested over a specified period and that permits withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Participant withdrawals from the plan are required to be at contract value.

Health and welfare benefit plan. A plan that provides the following:

1. Medical, dental, visual, psychiatric, or long-term health care; severance benefits; life insurance; accidental death or dismemberment benefits
2. Unemployment, disability, vacation or holiday benefits
3. Apprenticeships, tuition assistance, day-care, housing subsidies, or legal services benefits

Investment fund option. An investment alternative provided to a participant in a defined contribution plan. The alternatives are usually pooled fund vehicles, such as registered investment companies (meaning, mutual funds), commingled funds of banks, or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds. The participant may select from among the various available alternatives and periodically change that selection.

Appendix L

Schedule of Changes Made to Audits of Employee Benefit Plans

Reference	Change	Date
Preface	Conformed to the terminology used in SAS No. 78.	April, 1997
Preface	Revised to include a discussion of FASB Statement No. 133.	June, 1999
Preface	Revised to reflect the issuance of FASB Statement No. 137, SOP 99-2, and SOP 99-3.	May, 2000
Paragraph 1.01	Modified to update statistics.	May, 1993
Paragraph 1.02	Reference to FASB Statement No. 110 added.	May, 1993
Paragraph 1.02	Reference to GASB Statements No. 25 and No. 26 added.	September, 1996
Paragraph 1.06	Updated to reflect the issuance of SOP 92-6.	May, 1993
Paragraph 1.07	Reference to SOP 92-6 added; Outdated information deleted.	May, 1993
Paragraph 1.07	Revised to reflect the issuance of SOP 99-3.	May, 2000
Paragraph 1.08	Added; Subsequent paragraphs renumbered.	September, 1996
Paragraph 1.08	Revised to reflect the issuance of SOP 99-3.	May, 2000
Renumbered paragraph 1.09	Added to reflect the issuance of SOP 99-2 and SOP 99-3; Subsequent paragraphs renumbered.	May, 2000
Renumbered paragraph 1.12	Caption added.	May, 1992
Renumbered paragraph 1.16	Paragraph added; Subsequent paragraphs renumbered.	May, 1992
Renumbered paragraph 1.17	Revised to more accurately reflect the benefits provided by an independent audit.	May, 1993
Renumbered paragraph 1.24	Footnote * added.	May, 2000
Paragraph 2.01	Reference to FASB Statement No. 110 added.	May, 1993
Paragraph 2.03	Exhibit 2-1 added.	April, 1998
Paragraph 2.04	Added; Subsequent paragraphs renumbered.	May, 2000
Renumbered paragraph 2.08(*a*) (footnote 3)	Footnote added.	May, 1992
Renumbered paragraph 2.10	Modified.	September, 1996

Reference	Change	Date
Renumbered paragraph 2.13	Updated to reflect the issuance of FASB Statement No. 110.	May, 1993
Renumbered paragraphs 2.17 and 2.18	Added to reflect the issuance of FASB Statement No. 121; Subsequent paragraphs renumbered; Footnote 4a added.	September, 1996
Renumbered paragraph 2.18	Footnote 4a deleted.	April, 1997
Renumbered paragraph 2.19	Revised to clarify that benefit-related amounts shouldn't be accrued on the statement of net assets available for benefits.	May, 1993
Renumbered paragraph 2.27(*g*)	Parenthetical added.	May, 1994
Renumbered paragraph 2.28	Reference to FASB Statement No. 119 added.	May, 1995
Renumbered paragraph 2.30	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Renumbered paragraph 2.30	Divided into paragraphs 2.29 and 2.30; Subsequent paragraphs further renumbered.	September, 1996
Renumbered paragraph 2.31 (footnote *)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraph 2.32	Added to add master trust reporting & disclosure requirements.	May, 1994
Renumbered paragraphs 2.33 and 2.34	Added to conform the guide to the requirements of FASB Statement No. 107; Subsequent paragraphs renumbered.	May, 1994
Renumbered paragraphs 2.33 and 2.34	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Renumbered paragraphs 2.33 and 2.34	Revised to reflect the issuance of FASB Statement No. 126; Footnote ** added.	April, 1997
Renumbered paragraphs 2.33 and 2.34	Footnote * added and footnote ** revised to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraphs 2.35 and 2.36	Added to reflect the issuance of FASB Statement No. 119; Subsequent paragraphs renumbered.	May, 1995
Paragraph 2.35 (footnote *)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999
Paragraphs 2.37, 2.38, 2.39, 2.40, 2.41, 2.42, and 2.43	Added to reflect the issuance of SOP 99-2; Subsequent paragraphs further renumbered.	August, 1999
Renumbered paragraphs 2.44, 2.45, 2.46, and 2.47	Added to reflect the issuance of SOP 94-6; Subsequent paragraphs further renumbered.	September, 1996

Reference	Change	Date
Renumbered paragraphs 2.46 and 2.47 (footnote *)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraph 2.49	Divided into paragraphs 2.48 and 2.49; Subsequent paragraphs further renumbered.	September, 1996
Chapter 3	Note added to reflect the issuance of SOP 99-3.	October, 1999
Chapter 3	Note deleted.	May, 2000
Paragraph 3.01	Exhibit 3-1 added.	April, 1998
Paragraph 3.01	Exhibit 3-1 revised to reflect the issuance of SOP 99-2 and SOP 99-3.	May, 2000
Paragraph 3.09	Revised to reflect the issuance of SOP 99-3.	December, 1999
Paragraph 3.10 (footnote 8)	Footnote added.	May, 1992
Paragraph 3.11	Revised to reflect the issuance of SOP 99-3.	December, 1999
Paragraph 3.12	Modified; Footnote * added.	September, 1996
Paragraph 3.12	Footnote * deleted.	April, 1997
Paragraph 3.13	Added to reflect the issuance of SOP 94-4; Subsequent paragraphs renumbered.	September, 1996
Renumbered paragraph 3.14	Modified.	September, 1996
Paragraph 3.15	Replaced with new paragraphs 3.16 through 3.19 to reflect the issuance of SOP 94-4; Subsequent paragraphs further renumbered.	September, 1996
Paragraph 3.16	Heading and footnote ** deleted.	April, 1997
Renumbered paragraph 3.20	Modified to add "loans to participants" to the first sentence.	May, 1992
Renumbered paragraph 3.20	Revised to reflect the issuance of SOP 99-3.	December, 1999
Paragraph 3.23	Added to reflect the issuance of FASB Statement No. 121; Subsequent paragraphs further renumbered; Footnote 9a added.	September, 1996
Paragraph 3.23	Footnote 9a deleted.	April, 1997
Renumbered paragraph 3.24	Revised to clarify that benefit-related amounts shouldn't be accrued on the statement of net assets available for benefits.	May, 1993
Renumbered paragraph 3.24	Revised to reflect the issuance of SOP 99-3.	December, 1999
Renumbered paragraph 3.27	Modified.	September, 1996
Renumbered paragraph 3.28(*g*)	Parenthetical added.	May, 1994

Reference	Change	Date
Renumbered paragraph 3.28(*g*)	Revised to reflect the issuance of SOP 99-3.	December, 1999
Renumbered paragraph 3.28(*k*)	Revised to clarify the requirements.	May, 1994
Renumbered paragraph 3.28(*k*)	Revised to reflect the issuance of Practice Bulletin 12.	May, 1995
Renumbered paragraph 3.28(*k*)	Revised to reflect the issuance of SOP 99-3.	December, 1999
Renumbered paragraph 3.28(*l*)	Last sentence added to clarify guidance on which defined contribution plans should make these financial statement disclosures.	April, 1997
Renumbered paragraph 3.28(*l*)	Deleted; Subsequent paragraphs relettered.	December, 1999
Renumbered paragraph 3.28(*l*)	Revised to clarify that benefit-related amounts shouldn't be accrued on the statement of net assets available for benefits.	May, 1993
Renumbered paragraph 3.28(*l*)	Penultimate sentence deleted and last sentence modified.	May, 1995
Renumbered paragraph 3.28(*n*)	Added.	May, 1995
Renumbered paragraph 3.28 (*o*, *p*, and *q*)	Added to reflect the issuance of SOP 94-4.	September, 1996
Paragraph 3.28(*o*)	Reference to FASB Statement No. 126 added.	April, 1998
Renumbered paragraph 3.28(*o*)	Revised to reflect the issuance of SOP 99-3.	December, 1999
Renumbered paragraph 3.29	Reference to FASB Statement No. 35 deleted.	May, 1994
Renumbered paragraph 3.29	Reference to FASB Statement No. 119 added.	May, 1995
Renumbered paragraph 3.31	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Renumbered paragraph 3.33	Added to add master trust reporting & disclosure requirements.	May, 1994
Renumbered paragraphs 3.34 and 3.35	Added to conform the guide to the requirements of FASB Statement No. 107; Subsequent paragraphs renumbered.	May, 1994
Renumbered paragraph 3.34	Reference to FASB Statement No. 119 added.	May, 1995

Reference	Change	Date
Renumbered paragraph 3.34	Revised to reflect the issuance of FASB Statement No. 126; Footnote ** added.	April, 1997
Renumbered paragraph 3.34	Footnote * added and footnote ** revised to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraph 3.35	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Renumbered paragraph 3.35	Revised to reflect the issuance of FASB Statement No. 126; Footnote ** added.	April, 1997
Renumbered paragraph 3.35	Footnote * added and footnote ** revised to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraphs 3.36 and 3.37	Added to reflect the issuance of FASB Statement No. 119; Subsequent paragraphs renumbered.	May, 1995
Renumbered paragraphs 3.36 and 3.37 (footnote *)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999
Paragraphs 3.38, 3.39, 3.40, and 3.41	Added to reflect the issuance of SOP 94-6; Subsequent paragraphs further renumbered.	September, 1996
Paragraphs 3.42 and 3.43	Added to provide guidance on Employee Stock Ownership Plans (ESOPs); Subsequent paragraphs further renumbered.	April, 1997
Paragraphs 3.44 and 3.45	Added; Subsequent paragraphs renumbered.	April, 1998
Paragraph 3.45	Revised to reflect the issuance of New Form 5500.	May, 2000
Renumbered paragraph 3.47	Divided into paragraphs 3.47 and 3.48; Subsequent paragraph further renumbered.	September, 1996
Chapter 4	The chapter has been divided into chapters 4A and 4B. Chapter 4A incorporates the provisions of SOP 92-6 for plans that have adopted SOP 92-6. Chapter 4B maintains the existing guidance for those plans that have not yet adopted SOP 92-6. Former paragraphs 4.01 through 4.26 renumbered as 4.63 through 4.88 (subsequently renumbered). Footnotes also renumbered. Additional revisions and editorial changes have been made throughout the chapter.	May, 1995
Chapter 4	Exhibit 4-1 added.	April, 1998
Chapter 4	Note revised.	June, 1999
Chapter 4	Note added to reflect the issuance of SOP 99-3.	October, 1999
Chapter 4 (Note)	Note revised to reflect the issuance of SOP 99-3.	December, 1999

Reference	Change	Date
Chapter 4	Exhibit 4-1 revised to reflect the issuance of SOP 99-3.	December, 1999
Chapter 4	Chapter 4A is now Chapter 4, Chapter 4B is deleted, and Note at beginning of chapter is deleted, all due to the DOL reversing their nonenforcement policy regarding SOP 92-6.	May, 2000
Chapter 4	Exhibit 4-1 revised to reflect the issuance of SOP 99-2 and SOP 99-3.	May, 2000
Paragraph 4.09	Revised to clarify the auditor's responsibility in auditing Voluntary Employees' Beneficiary Associations (VEBAs).	April, 1997
Renumbered paragraph 4.20	Revised to reflect the issuance of SOP 99-3.	December, 1999
Paragraph 4.23	Modified.	September, 1996
Paragraph 4.24	Replaced with new paragraphs 4.24 through 4.29 to reflect the issuance of SOP 94-4; Subsequent paragraphs renumbered; Footnote 22 replaced.	September, 1996
Paragraph 4.24	Heading and footnote 22 deleted.	April, 1997
Paragraph 4.36	Added to reflect the issuance of FASB Statement No. 121; Subsequent paragraphs further renumbered; Footnote 23a added.	September, 1996
Paragraph 4.36	Footnote 23a deleted.	April, 1997
Paragraphs 4.54 and 4.55	Added to reflect the issuance of SOP 99-2; Subsequent paragraphs further renumbered.	August, 1999
Renumbered paragraph 4.59	Last three bullets added to reflect the issuance of SOP 94-4.	September, 1994
Renumbered paragraph 4.62	Divided into paragraphs 4.62 and 4.63; Subsequent paragraphs further renumbered.	September, 1996
Renumbered paragraphs 4.64 and 4.65	Revised to reflect the issuance of FASB Statement No. 126; Footnote * added.	April, 1997
Renumbered paragraphs 4.64 and 4.65 (footnote *)	Revised to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraph 4.65	Revised and footnote ** added to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraph 4.66 (footnote **)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraphs 4.68, 4.69, 4.70, and 4.71	Added to reflect the issuance of SOP 94-6; Subsequent paragraphs further renumbered.	September, 1996
Renumbered paragraph 4.70 (footnote *)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999

Reference	Change	Date
Renumbered paragraphs 4.76, 4.77, and 4.78	Added to provide guidance on VEBAs; Subsequent paragraphs further renumbered.	April, 1997
Renumbered paragraph 4.86 (footnote 40)	Footnote added.	May, 1992
Renumbered paragraph 4.87	Modified.	September, 1996
Paragraph 4.72	Replaced with new paragraphs 4.83 through 4.88 (renumbered as 4.86 through 4.91 in April, 1997; Further renumbered as 4.88 through 4.93 in August, 1999) to reflect the issuance of SOP 94-4; Subsequent paragraphs further renumbered; Footnote 43 replaced.	September, 1996
Renumbered paragraph 4.88	Heading and footnote 43 deleted.	April, 1997
Renumbered paragraph 4.97	Added to reflect the issuance of FASB Statement No. 121; Subsequent paragraphs further renumbered; Footnote 44a added.	September, 1996
Renumbered paragraph 4.97	Footnote 44a deleted.	April, 1997
Renumbered paragraph 4.110 (*i*, *j*, and *k*)	Added to reflect the issuance of SOP 94-4.	September, 1996
Renumbered paragraph 4.115	Revised to reflect the issuance of FASB Statement No. 126; Footnote ** added.	April, 1997
Renumbered paragraph 4.115	Footnote * added and footnote ** revised to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraph 4.116	Revised to reflect the issuance of FASB Statement No. 126; Footnote ** added.	April, 1997
Renumbered paragraph 4.116	Footnote ** revised and footnote *** added to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraphs 4.117 and 4.118 (footnote *)	Added to reflect the issuance of FASB Statement No. 133.	June, 1999
Renumbered paragraphs 4.119, 4.120, 4.121, and 4.122	Added to reflect the issuance of SOP 94-6.	September, 1996
Renumbered paragraphs 4.123, 4.124, and 4.125	Added to provide guidance on VEBAs.	April, 1997
Paragraph 5.01	Revised to reflect the issuance of SAS No. 83.	April, 1998

Reference	Change	Date
Paragraph 5.01	Footnote * added to reflect the issuance of SAS No. 89.	May, 2000
Paragraph 5.02	Text added.	May, 1992
Paragraph 5.02	References to Exhibits added.	May, 1992
Paragraph 5.02	Sentence added relating to "limited scope exemptions."	May, 1993
Paragraph 5.02	Clarified to provide additional guidance on the use of SAS No. 70 reports in the limited scope audit.	April, 1997
Paragraph 5.02	Revised to clarify guidance.	May, 2000
Exhibit 5-1	Exhibit updated.	May, 1993
Exhibit 5-1 (footnote *)	Added.	April, 1997
Exhibit 5-2	Exhibits updated.	May, 1993
Exhibit 5-2	Note B revised to reflect the issuance of New Form 5500.	May, 2000
Exhibit 5-3	Exhibit updated.	May, 1993
Exhibit 5-3	Note 7 revised.	April, 1998
Paragraph 5.04	Revised by adding reference to renumbered paragraphs 13.15 through 13.17.	May, 1994
Paragraph 5.05	References to Exhibits added.	May, 1992
Paragraph 5.06	Added; Subsequent paragraphs renumbered.	May, 1994
Paragraph 5.06	Revised to reflect the issuance of SAS No. 83 and other relevant issues.	April, 1998
Paragraph 5.06	Footnote * added to reflect the issuance of SAS No. 89.	May, 2000
Exhibit 5-4	Replaced to reflect the issuance of SAS No. 83.	April, 1998
Exhibit 5-4	Footnote * added to reflect the issuance of SAS No. 89; Subsequent footnotes renumbered.	May, 2000
Paragraph 5.07	Reference to SAS No. 77 added.	September, 1996
Renumbered paragraph 5.09	Reference to SAS No. 22 added.	May, 1992
Paragraph 5.11	Revised to reflect the issuance of SAS No. 82.	April, 1998
Paragraph 5.12	Text added.	May, 1993
Paragraph 5.14	References to SAS Nos. 36 and 66 deleted. Reference to SAS No. 71 added.	May, 1993
Paragraph 5.15	Revised to reflect the issuance of SAS No. 82.	April, 1998
Paragraph 5.15	Footnote * added to reflect the issuance of SOP 99-2 and SOP 99-3.	May, 2000
Paragraph 5.16	Revised to reflect the issuance of SAS No. 82.	April, 1998
Paragraph 5.16	Revised to clarify guidance.	May, 2000
Paragraph 5.18	Revised to reflect the issuance of SAS No. 82.	April, 1998
Paragraph 5.18	Revised to clarify guidance.	May, 2000

Reference	Change	Date
Paragraph 5.20	Replaced with new paragraphs 5.20 through 5.24; Subsequent paragraphs renumbered.	April, 1998
Paragraph 5.20	Footnote * revised.	May, 2000
Renumbered paragraph 5.25	Revised to reflect the issuance of SAS No. 70.	May, 1993
Renumbered paragraph 5.25	Revised to reflect the issuance of SAS No. 78.	April, 1997
Renumbered paragraph 5.25	Revised to reflect the issuance of SAS No. 82.	April, 1998
Renumbered paragraph 5.26	Replaced to provide additional guidance on the use of SAS No. 70 reports.	April, 1997
Renumbered paragraph 5.26	Revised to reflect the issuance of SAS No. 88.	May, 2000
Renumbered paragraph 5.29	Reference to paragraph 11.15 added.	May, 1993
Paragraphs 5.32 and 5.33	Deleted.	April, 1998
Renumbered paragraph 5.36	Revised to reflect the issuance of SAS No. 82.	April, 1998
Renumbered paragraphs 5.39 and 5.40	References to SAS No. 77 added.	September, 1996
Chapter 6	Revised to reflect the issuance of SAS No. 78.	April, 1997
Paragraphs 6.01, 6.04, 6.05, and 6.06	Revised to reflect the issuance of SAS No. 88.	May, 2000
Paragraphs 6.06, 6.07, and 6.08	Replaced with paragraphs 6.06 through 6.12 (renumbered as paragraphs 6.06 through 6.13, April, 1998) to clarify SAS No. 70 guidance; Subsequent paragraphs renumbered.	May, 1995
Paragraph 6.07	Reference to Auditing Procedure Study on implementing SAS No. 70 added.	September, 1996
Paragraph 6.07	Revised to reflect the issuance of SAS No. 88.	May, 2000
Paragraph 6.10	Added; Subsequent paragraphs renumbered.	April, 1998
Paragraph 6.11	Added to include guidance on SAS No. 70; Subsequent paragraphs renumbered.	May, 2000
Renumbered paragraphs 6.12 and 6.13	Revised to reflect the issuance of SAS No. 88.	May, 2000
Renumbered paragraph 6.14	Added; Subsequent paragraphs further renumbered.	September, 1996
Renumbered paragraph 6.14	Revised to clarify guidance.	May, 2000
Renumbered paragraph 6.15	Added; Subsequent paragraphs further renumbered.	April, 1997
Renumbered paragraph 6.15	Last bullet deleted.	April, 1998

Reference	Change	Date
Renumbered paragraphs 6.15 and 6.16	Revised to reflect the issuance of SAS No. 88.	May, 2000
Renumbered paragraph 6.17	Revised to reflect the issuance of SAS No. 82.	April, 1998
Paragraph 7.12	Revised to reflect the issuance of SAS No. 81.	April, 1998
Paragraph 7.12(*h*)	References to SAS No. 11 changed to SAS No. 73.	May, 1995
Paragraph 7.12(*k*)	Added.	May, 1993
Paragraph 7.12	Revised and Footnote * added.	May, 2000
Paragraph 7.13	Revised to reflect the issuance of SAS No. 78.	April, 1997
Paragraph 7.15	Revised to reflect the issuance of SAS No. 70.	May, 1993 and 1994
Paragraph 7.15	Reference to SAS No. 79 added.	September, 1996
Paragraph 7.15	Revised to reflect the issuance of SAS No. 78.	April, 1997
Paragraph 7.18(*c*)	Revised to reflect the issuance of SAS No. 70.	May, 1993 and 1994
Paragraph 7.18	Reference to SAS No. 79 added.	September, 1996
Paragraph 7.18	Revised to reflect the issuance of SAS No. 78.	April, 1997
Paragraph 7.18	Revised to reflect the issuance of SAS No. 88.	May, 2000
Paragraphs 7.19, 7.20, and 7.21	Added to provide guidance on mutual funds; Subsequent paragraphs renumbered.	April, 1997
Paragraphs 7.20 and 7.21	Former paragraph 7.20 modified and renumbered as paragraph 7.21; Former paragraph 7.21 renumbered as paragraph 7.20.	April, 1998
Paragraph 7.22	Revised to clarify guidance.	May, 2000
Renumbered paragraph 7.26 (heading)	Modified.	September, 1996
Renumbered paragraph 7.39 (footnote 57)	Revised to reflect the issuance of SOP 94-4.	September, 1996
Renumbered paragraph 7.39 (footnote 57)	Last sentence deleted.	April, 1997
Renumbered paragraph 7.40	Revised to reflect the issuance of SOP 94-4.	September, 1996
Renumbered paragraph 7.40 (footnote *)	Deleted.	April, 1997
Paragraph 7.41	Added to provide guidance on synthetic guaranteed investment contracts to reflect the information provided in the appendix of SOP 94-4; Subsequent paragraphs further renumbered.	April, 1997

Reference	Change	Date
Renumbered paragraph 7.42	Modified.	September, 1996
Renumbered paragraph 7.43	Revised to reflect the issuance of FASB Statement No. 110.	May, 1995
Renumbered paragraph 7.43	Modified; Footnote * added to reflect the issuance of SOP 94-4.	September, 1996
Renumbered paragraph 7.43 (footnote *)	Deleted.	April, 1997
Renumbered paragraph 7.43(*d*)	Added to provide guidance on synthetic guaranteed investment contracts to reflect the information provided in the appendix of SOP 94-4; Subsequent paragraphs further renumbered.	April, 1997
Renumbered paragraph 7.44	Reference to SAS No. 35 changed to SAS No. 75.	September, 1996
Renumbered paragraph 7.44	Modified.	April, 1998
Renumbered paragraph 7.45	Revised to reflect the issuance of SAS No. 70.	May, 1993 and 1994
Renumbered paragraph 7.45	Revised to reflect the issuance of SAS No. 78.	April, 1997
Renumbered paragraph 7.45	Revised to reflect the issuance of SAS No. 88.	May, 2000
Renumbered paragraph 7.46	Reference to SAS No. 79 added.	September, 1996
Renumbered paragraphs 7.47 and 7.48	Added to provide guidance on auditing participant loans; Subsequent paragraphs renumbered.	May, 1995
Renumbered paragraph 7.48(*f*)	Text added to provide guidance on loans in default.	April, 1997
Renumbered paragraph 7.48(*f*)	Replaced.	April, 1998
Renumbered paragraph 7.50	(*f*) under "For loans and mortgages" added.	May, 1993
Paragraph 7.51	Added; Subsequent paragraphs renumbered.	June, 1999
Renumbered paragraph 7.52	Paragraph modified.	May, 1992
Renumbered paragraph 7.52	Revised for clarity.	May, 1994
Renumbered paragraph 7.52	Revised to reflect the issuance of SAS No. 78.	April, 1997
Renumbered paragraph 7.53	Added.	May, 1994
Paragraph 8.06(*c*)	Added.	April, 1998
Paragraph 8.06(*d*)	Added to provide guidance on the new Department of Labor (DOL) remittance rules for pension benefit plans.	April, 1997
Paragraph 8.07	Added.	April, 1998

Reference	Change	Date
Paragraph 9.03(*a*)	Revised.	April, 1998
Paragraph 9.03(*e*)	Revised.	May, 1994
Paragraphs 9.03(*f*) and 9.03(*g*)	Added.	May, 1994
Paragraph 9.03	Revised to clarify guidance.	May, 2000
Paragraph 9.04	Reference changed from SAS No. 44 to SAS No. 70.	May, 1993
Paragraph 9.04	Footnote * added.	April, 1998
Paragraph 9.04	Revised to reflect the issuance of SAS No. 88.	May, 2000
Paragraph 9.05	Added.	April, 1998
Paragraph 10.01	Reference to SAS No. 11 changed to SAS No. 73.	May, 1995
Paragraph 10.03	Revised.	April, 1998
Paragraph 10.05	Revised to clarify guidance.	May, 2000
Paragraph 10.06	Reference to SAS No. 79 added.	September, 1996
Paragraph 10.06	Revised to reflect the issuance of SAS No. 78.	April, 1997
Paragraph 10.06	Revised to clarify guidance.	May, 2000
Paragraphs 10.07, 10.08, and 10.09	Added; Subsequent paragraphs renumbered.	May, 2000
Renumbered paragraph 10.10	Revised to reflect the issuance of SAS No. 73.	May, 1995
Renumbered paragraphs 10.20, 10.21, and 10.23	References to SAS No. 11 changed to SAS No. 73.	May, 1995
Paragraph 10.28	Added; Subsequent paragraphs further renumbered.	May, 2000
Renumbered paragraph 10.29	Revised to clarify guidance.	May, 2000
Renumbered paragraph 10.30	Revised to reflect the issuance of SAS No. 78.	April, 1997
Renumbered paragraph 10.30	Revised to clarify guidance.	May, 2000
Paragraph 10.32	Added; Subsequent paragraphs further renumbered.	May, 2000
Paragraph 11.03	Revised to provide an example of an exempt party in interest transaction that is not required to be reported on the Form 5500 or related schedules.	May, 1994
Paragraph 11.09	Modified.	April, 1998
Paragraphs 12.02 and 12.03	Revised to clarify guidance.	May, 1995
Paragraph 12.03(*a*)	Updated to reflect proposed changes to the tax status notes in the illustrative financial statements.	May, 1993
Paragraph 12.03 (*a* and *b*)	Revised to clarify auditing guidance for VEBAs; Footnote * added.	April, 1997
Paragraph 12.04(*d*)	Revised to reflect the issuance of SAS No. 85.	April, 1998

Reference	Change	Date
Paragraph 12.04	Revised to reflect the issuance of SAS No. 89.	May, 2000
Paragraph 12.06	Updated to clarify the ABA/AICPA understanding with regard to attorney's letter.	May, 1993
Paragraph 12.11	Added; Subsequent paragraphs renumbered.	September, 1996
Paragraph 12.11	Revised.	April, 1998
Paragraphs 12.12 and 12.13	Added; Subsequent paragraphs renumbered.	April, 1998
Renumbered paragraph 12.14	Added; Subsequent paragraphs renumbered.	September, 1996
Renumbered paragraph 12.14	Revised to clarify guidance.	May, 2000
Paragraphs 12.15, 12.16, and 12.17	Added; Subsequent paragraphs further renumbered.	April, 1998
Paragraph 12.17a	Added.	June, 1999
Renumbered paragraph 12.18	Replaced.	April, 1998
Renumbered paragraph 12.18	Revised; Footnote * added to reflect the issuance of SAS No. 89.	May, 2000
Paragraph 12.19	Added.	April, 1998
Paragraph 12.19	Revised; Footnote ** added to reflect the issuance of SAS No. 89.	May, 2000
Exhibit 12-1	Added.	April, 1998
Exhibit 12-1	Footnote * added to reflect the issuance of SAS No. 89; Subsequent footnotes renumbered.	May, 2000
Renumbered paragraphs 12.20, 12.21, and 12.22	Added to provide SEC reporting guidance; Subsequent paragraphs further renumbered.	April, 1997
Renumbered paragraphs 12.26 and 12.27	Added.	May, 1994
Renumbered paragraph 12.28	Added to provide guidance on accessing auditors' workpapers.	April, 1997
Paragraph 13.02	Revised to clarify guidance.	May, 1995
Paragraph 13.02	Reference to SAS No. 79 added.	September, 1996
Paragraph 13.03	Revised to clarify guidance.	May, 2000
Paragraph 13.04	Note reference to SOP 93-3 added.	May, 1993
Paragraph 13.04	Corrected to cover two years of accumulated plan benefits as required by ERISA.	May, 1995
Paragraph 13.04	Revised to clarify guidance.	May, 2000
Paragraph 13.06	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Paragraph 13.07	Deleted.	June, 1999

Reference	Change	Date
Paragraph 13.08	Paragraph added (illustrative auditor's report for health and welfare plans that have adopted SOP 92-6); Subsequent paragraphs renumbered.	May, 1993
Paragraphs 13.08 and 13.11	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Paragraph 13.11	Added; Subsequent paragraphs renumbered.	April, 1998
Renumbered paragraph 13.12	Revised.	April, 1998
Renumbered paragraph 13.12	Revised to clarify guidance.	May, 2000
Renumbered paragraph 13.14	Revised to clarify the auditor's reporting responsibility in situations where he or she becomes aware of a departure from DOL filing requirements that is not related to a prohibited transaction with a party in interest.	May, 1993
Renumbered paragraphs 13.15–13.17	Added; Subsequent paragraphs renumbered.	May, 1994
Renumbered paragraphs 13.16 and 13.17	Revised to reflect the issuance of New Form 5500.	May, 2000
Renumbered paragraph 13.17	Modified report for a limited-scope engagement corrected to be consistent with the table in renumbered paragraph 13.16.	May, 1995
Renumbered paragraph 13.17	Revised.	April, 1998 and June, 1999
Renumbered paragraphs 13.18 and 13.19	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Renumbered paragraphs 13.18 and 13.19	Revised.	April, 1998
Renumbered paragraph 13.21	Reference to SAS No. 77 added.	September, 1996
Renumbered paragraph 13.21	Revised to reflect an interpretation of SAS No. 62.	June, 1999
Renumbered paragraph 13.22	Revised.	April, 1998
Renumbered paragraph 13.23	Examples added.	May, 1995
Renumbered paragraph 13.23	Reference to SAS No. 77 added.	September, 1996
Renumbered paragraph 13.23	Revised.	June, 1999

Reference	Change	Date
Renumbered paragraph 13.26	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Renumbered paragraph 13.26	Revised to clarify guidance.	May, 2000
Renumbered paragraph 13.27	Added to provide guidance on limited scope engagements; Subsequent paragraphs further renumbered.	April, 1997
Renumbered paragraph 13.28	Revised.	April, 1998
Renumbered paragraph 13.29	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Renumbered paragraph 13.29	Revised to clarify guidance.	May, 2000
Renumbered paragraph 13.30	Footnote * added.	April, 1998
Renumbered paragraph 13.30	Revised to clarify guidance.	May, 2000
Paragraphs 13.31 and 13.32	Replaced by new paragraphs 13.31 through 13.34 (renumbered as 13.33 through 13.36 in April, 1998); Subsequent paragraphs renumbered.	September, 1996
Renumbered paragraph 13.34	Revised to reflect the issuance of SAS No. 81.	April, 1998
Renumbered paragraph 13.34	Footnote * added.	May, 2000
Renumbered paragraph 13.36	Revised.	April, 1998
Renumbered paragraph 13.36	Revised to clarify guidance.	May, 2000
Renumbered paragraph 13.37	Revised to reflect the issuance of SAS No. 70.	May, 1993
Renumbered paragraph 13.37	Revised to reflect the issuance of SAS No. 78.	April, 1997
Renumbered paragraph 13.38	Revised to address the auditor's responsibility for reporting on information related to separate investment fund options and to expand the discussion to relate to all situations rather than just financial statements filed with the SEC.	May, 1994
Renumbered paragraphs 13.39 and 13.40	Added; Subsequent paragraphs renumbered.	May, 1995
Renumbered paragraph 13.40	Revised to clarify guidance.	May, 1995
Renumbered paragraph 13.40	Revised.	April, 1998

Reference	Change	Date
Renumbered paragraphs 13.39 and 13.40	Deleted to reflect the issuance of SOP 99-3; Subsequent paragraphs renumbered.	May, 2000
Renumbered paragraph 13.40	Reference to SAS No. 77 added.	September, 1996
Renumbered paragraphs 13.41 and 13.42	Added.	May, 1993
Appendix A, paragraph A.14	Last sentence replaced & footnote added.	May, 1994
Appendix A, paragraph A.14	Text added to clarify new remittance rules.	April, 1997
Appendix A, paragraph A.20	Last sentence replaced and footnote added.	May, 1994
Appendix A, paragraph A.22	"Tax-qualified" deleted from second sentence; Last sentence replaced.	May, 1994
Appendix A, paragraph A.23	Footnote 58 restated.	May, 1994
Appendix A, paragraph A.25	Parenthetical in first bullet under "General Exemption From Audit Requirement Only" replaced.	May, 1994
Appendix A, paragraph A.28	Penultimate sentence revised.	May, 1994
Appendix A, paragraphs A.42*b* and A.42*c*	Text added.	May, 1992
Appendix A, paragraph A.57	Last two sentences added to provide guidance on limited scope audits.	April, 1997
Appendix A, paragraph A.59	Added to provide guidance on limited scope audits; Subsequent paragraphs renumbered.	April, 1997
Appendix A, Exhibit A-1	Footnote deleted.	May, 1992
Appendix A, Exhibit A-1	Footnote * revised to provide guidance on the Form 5500 schedules.	April, 1997
Appendix A	Incorporated the information contained in Exhibit A-4 into the text of Appendix A to make it more easily accessible.	May, 1993
Appendix A	Revised to reflect the issuance of New Form 5500.	May, 2000
Appendix B	Revised to reflect the issuance of SAS No. 78.	April, 1997
Appendix B	Revised to provide further guidance on SAS No. 70.	May, 2000
Appendix C	Revised to reflect the issuance of FASB Statement No. 135.	May, 2000
Appendix D	Introductory material modified.	May, 1993
Appendix D	Exhibits D-1 and D-2 revised.	May, 1994
Appendix D	Exhibit D-3 presented on comparative basis to reflect ERISA's minimum disclosure requirements.	May, 1993

Reference	Change	Date
Appendix D	Exhibit D-5, D-6, D-7, D-8, and Notes to financial statements revised.	May, 1994
Appendix D	Notes to financial statements revised.	April, 1998
Appendix D	Exhibits D-9, D-10, and D-11 added to reflect the issuance of SOP 99-2.	August, 1999
Appendix D	Revised to reflect the issuance of SOP 99-2 and SOP 99-3.	May, 2000
Appendix E	Introductory material modified.	May, 1994
Appendix E	Illustration 1 added, (401(k) Plan financial statements); Subsequent illustrations renumbered.	May, 1994
Appendix E	Illustration 1 further identified as Exhibits E-1 through E-5.	April, 1997
Appendix E	Notes to the financial statements of illustration 1 revised to reflect the disclosure requirements related to forfeitures.	May, 1995
Appendix E	Note added to reflect the issuance of SOP 99-3.	October, 1999
Appendix E, Exhibit E-5	Revised to reflect SOP 94-4 disclosures.	April, 1997
Appendix E	Renumbered illustration 2 (profit-sharing plan): Statement of net assets available for benefits revised to illustrate the ERISA requirement for comparative statements; Notes to financial statements revised.	May, 1994
Appendix E	Renumbered illustration 2 further identified as Exhibits E-6 through E-8.	April, 1997
Appendix E, Exhibit E-8	Revised to reflect SOP 94-4 disclosures.	April, 1997
Appendix E	Renumbered illustration 3 (employee stock ownership plan) statements of changes in net assets available for benefits revised to reflect only one year.	May, 1994
Appendix E	Notes to financial statements revised.	April, 1998
Appendix E	Renumbered illustration 3 further identified as Exhibits E-9 through E-11.	April, 1997
Appendix E, Exhibit E-9	Revised to reflect SOP 94-4 disclosures.	April, 1997
Appendix E, Exhibit E-10	Modified.	April, 1998
Appendix E	Exhibits E-1 through E-3 revised to reflect the issuance of SOP 99-3; Exhibits E-4 and E-5 deleted; Subsequent Exhibits renumbered.	December, 1999
Appendix E	Revised to reflect the issuance of SOP 99-2 and SOP 99-3.	May, 2000
Appendix F	Added (illustrative financial statements from SOP 92-6); Subsequent appendixes relettered.	May, 1995

Reference	Change	Date
Appendix F	Notes to financial statements revised.	April, 1998 and June, 1999
Appendix F	Exhibit A further identified as Exhibits F-1 through F-5; Exhibit B further identified as Exhibits F-6 through F-8.	April, 1997
Appendix F	Exhibits F-9, F-10, F-11, F-12, and F-13 added to reflect the issuance of SOP 99-2.	August, 1999
Appendix F	Revised to reflect the issuance of SOP 99-2 and SOP 99-3.	May, 2000
Relettered Appendix G	Illustrative financial statement notes added.	December, 1991
Relettered Appendix G	Introduction clarified.	May, 1995
Relettered Appendix G	Notes to financial statements revised.	April, 1998
Relettered Appendix G	Illustrative financial statements and notes further identified as Exhibits G-1 through G-6.	April, 1997
Relettered Appendix G	Deleted; Subsequent appendixes relettered.	May, 2000
Relettered Appendix G	Revised.	April, 1997
Appendix H	SOP 94-4 added.	January, 1995
Appendix H	Paragraphs 1 through 19 of SOP 94-4 incorporated into chapters 3, 4, and 7.	September, 1994
Appendix I	Practice Bulletin 12 added.	January, 1995
Appendix I	Revised.	September, 1996
Appendix I	Note added to reflect the issuance of SOP 99-3.	October, 1999
Appendix I	Practice Bulletin 12 deleted; Subsequent Appendixes relettered.	December, 1999
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Glossary	Terms revised to reflect the issuance of SOP 99-3.	December, 1999

> *Note:* The Glossary was revised in December 1999 to reflect the changes necessitated by the issuance of Statement of Position 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*. SOP 99-3 is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged. See SOP 99-3 in appendix L.

Glossary

accrued experience-rating adjustments. The refund at the end of the policy year of the excess of premiums paid over paid claims, reserves required by the insurance company, and the insurance company's retention (fee).

accumulated eligibility credits. A liability of a plan arising from prior employee service for which employer contributions have been received.

accumulated plan benefits. Benefits that are attributable under the provisions of an employee benefit plan to employees' service rendered to the benefit information date.

act. As used in FASB Statement No. 35, the Employee Retirement Income Security Act of 1974.

actuarial asset value. A value assigned by an actuary to the assets of a plan generally for use in conjunction with an actuarial cost method.

actuarial cost method. A recognized actuarial technique used for establishing the amount and incidence of employer contributions or accounting charges for pension cost under a pension plan.

actuarial value of accumulated plan benefits. The amount as of a benefit information date that results from applying actuarial assumptions to the accumulated plan benefits, with the actuarial assumptions being used to adjust those amounts to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the benefit information date and the expected date of payment.

allocated contract. A contract with an insurance company under which related payments to the insurance company are currently used to purchase immediate or deferred annuities for individual participants.

benefit information. The actuarial present value of accumulated plan benefits.

benefit information date. The date as of which the actuarial present value of accumulated plan benefits is presented.

benefit-responsive investment contract. A contract between an insurance company, a bank, a financial institution, or any financially responsible entity and a plan that provides for a stated return on principal invested over a specified period and that permits withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Participant withdrawals from the plan are required to be at contract value.

benefit security. As used in FASB Statement No. 35, the plan's present and future ability to pay benefits when due.

benefits. Payments to which participants may be entitled under an employee benefit plan, including pension benefits, disability benefits, death benefits, health benefits, and benefits due on termination of employment.

cash-or-deferred arrangement (section 401(k) plan). A plan that may be incorporated into a profit-sharing or stock bonus plan (a few pre-ERISA money purchase pension plans also incorporate cash-or-deferred arrangements). Under such an arrangement, a participant is permitted to elect to receive amounts in cash or have them contributed to the plan as employer contributions on the participant's behalf.

CFR. Code of Federal Regulations.

common or commingled trust. A trust for the collective investment and reinvestment of assets contributed from employee benefit plans maintained by more than one employer or a controlled group of corporations that is maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency.

contract value. The value of an unallocated contract that is determined by the insurance company in accordance with the terms of the contract.

contributions receivable. Amounts due as of the date of the financial statements, including legal or contractual obligations and, for a single employer plan, obligations resulting from a formal commitment.

contributory plan. An employee benefit plan under which participants bear part of the cost.

defined benefit pension plan. A pension plan that specifies a determinable pension benefit, usually based on factors such as age, years of service, and salary. Even though a plan may be funded pursuant to periodic agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined benefit pension plan.

defined contribution plan. A plan that provides an individual account for each participant and provides benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience, and (*c*) any forfeitures allocated to the account, less any administrative expenses charged to the plan.

deposit administration contract (DA). A type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Payments to the insurance company that are intended to provide future benefits to present employees are credited to an account. For investment purposes, the monies in the account are commingled with other assets of the insurance company. The account is credited with interest at the rate specified in the contract; it is charged with the purchase price of annuities when participants retire and with any incidental benefits (death, disability, and withdrawal) disbursed directly from the account.

directed trust. An arrangement in which the trustee acts as custodian of a plan's investments and is responsible for collecting investment income and handling trust asset transactions as directed by the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor.

discretionary trust. An arrangement in which the trustee has discretionary authority and control over investments and is authorized by the plan or its investment committee to make investment decisions.

employee. A person who has rendered or is presently rendering service.

employee stock ownership plan (ESOP). A stock bonus plan that borrows money from, or on the guarantee of, *a related party* (a *party in interest* as defined in section 3(14) of ERISA) for the purpose of acquiring securities issued by the plan sponsor and that invests primarily in such securities (a leveraged ESOP). The term "employee stock ownership plan" is also generally applied to (*a*) nonleveraged stock bonus plans that satisfy various requirements set forth in section 4975(e)(7) of the IRC and (*b*) profit-sharing plans (and certain pre-ERISA money purchase pension plans) that invest primarily in securities issued by the plan sponsor.

ERISA. The Employee Retirement Income Security Act of 1974.

ERISA plan. A plan that is subject to ERISA.

fair value. The amount that the plan could reasonably expect to receive for a plan investment in a current sale between a willing buyer and a willing seller.

Form 5500. A joint-agency form developed by the IRS, DOL, and PBGC, which may be used to satisfy the annual reporting requirements of the IRC and Titles I and IV or ERISA.

frozen plan. See *wasting trust.*

full-scope audit. An audit of the financial statements of an employee benefit plan in accordance with generally accepted auditing standards.

funding agency. An organization or individual, such as a specific corporate or individual trustee or an insurance company, that provides facilities for the accumulation of assets to be used for paying benefits under a plan; an organization, such as a specific life insurance company, that provides facilities for the purchase of such benefits.

funding policy. The program regarding the amounts and timing of contributions by the employer(s), participants, and any other sources (for example, state subsidies or federal grants) to provide the benefits a plan specifies.

general account. An undivided fund maintained by an insurance company that commingles plan assets with other assets of the insurance company for investment purposes. That is, funds held by an insurance company that are not maintained in a separate account are in its general account.

guaranteed investment contract (GIC). A contract between an insurance company and a plan that provides for a guaranteed return on principal invested over a specified time period.

health and welfare benefit plan. A plan that provides (*a*) medical, dental, visual, psychiatric, or long-term health care; severance benefits; life insurance; accidental death or dismemberment benefits; (*b*) unemployment, disability, vacation or holiday benefits; and (*c*) apprenticeships, tuition assistance, day-care, housing subsidies, or legal services benefits.

IBNR. Claims incurred by eligible participants but not yet reported to the plan.

immediate participation guarantee contract (IPG). A type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Payments to the insurance company that are intended to provide future benefits to present employees, plus its share of the insurance company's actual investment income, are credited to an account. The insurance company is obligated to make lifetime benefit payments to retired employees.

individual separate account. A separate account in which only one plan participates. Also referred to as a separate-separate account.

insured plan. A plan funded through an insurance contract.

investment fund option. An investment alternative provided to a participant in a defined contribution plan. The alternatives are usually pooled fund vehicles, such as registered investment companies (meaning, mutual funds), commingled funds of banks, or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds. The participant may select from among the various available alternatives and periodically change that selection.

investment unit. See *unit of participation.*

Keogh plan. Also called an HR 10 plan, any defined benefit or defined contribution plan that covers one or more self-employed individuals.

limited-scope audit. An audit in which ERISA allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to information prepared and certified by a bank or similar institution, or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency.

master trust. A combined trust account made up of assets of some or all of the employee benefit plans of a company that sponsors more than one plan or a group of corporations under common control. Each plan has an undivided interest in the assets of the trust, and ownership is represented by a record of proportionate dollar interest or by units of participation.

money purchase pension plan. A defined contribution plan under which employer contributions are based on a fixed formula that is not related to profit and that is designated as a pension plan by the plan sponsor.

multiemployer plan. A plan in which more than one employer is required to contribute that is maintained pursuant to one or more collective bargaining agreements.

multiple-employer plan. A plan that involves more that one employer and includes only plans whose contributions from individual employers are available to pay benefits to all participants.

named fiduciary. The individual responsible for the operation and administration of a plan including the identification of a plan administrator; usually an officer or other employee of the plan sponsor who reports to the plan sponsor's board of directors or management.

net asset information. Information regarding the net assets available for benefits.

net assets available for benefits. The difference between a plan's assets and its liabilities. For purposes of this definition, a plan's liabilities do not include participants' accumulated plan benefits.

noncontributory plan. An employee benefit plan under which participants do not make contributions.

nonvested benefit information. The actuarial present value of nonvested accumulated plan benefits.

participant. Any employee or former employee, or any member or former member of a trade or other employee association, or the beneficiaries of those individuals, for whom there are accumulated plan benefits.

participating contract. An allocated contract that provides for plan participation in the investment performance and experience (for example, mortality experience) of the insurance company.

participation right. A plan's right under a participating contract to receive future dividends from the insurance company.

party in interest. A fiduciary or employee of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee association whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee association, or relatives of such person just listed.

PBGC. The Pension Benefit Guaranty Corporation.

pension benefits. Periodic (usually monthly) payments made to a person who has retired from employment.

pension fund. The assets of a pension plan held by a funding agency.

pension plan. See *defined benefit pension plan.*

plan administrator. The person or group of persons responsible for the content and issuance of a plan's financial statements in much the same way that management is responsible for the content and issuance of a business enterprise's financial statements.

pooled separate account. A separate account in which several plans participate.

prior service costs. See *supplemental actuarial value.*

profit-sharing plan. A defined contribution plan that is not a pension plan (as defined in the IRC) or a stock bonus plan. Employer contributions may be discretionary or may be based on a fixed formula related to profits, compensation, or other factors. Before 1987, contributions had to be made from the plan sponsor's current or accumulated profits. This requirement is no longer in effect. A profit-sharing plan must be designated as such in the plan document.

prohibited transaction. A transaction between a plan and a party in interest that is prohibited under section 406(a) of ERISA.

reporting date. The date of which information regarding the net assets available for benefits is presented.

retired life fund. That portion of the funds under an immediate participation guarantee contract that is designated as supporting benefit payments to current retirees.

self-directed plan. A defined contribution plan in which the participant authorizes specific investment transactions, such as purchases and sales of specific common stocks or bonds. A self-directed plan does not provide predetermined investment fund options.

self-funded plan. A plan funded through accumulated contributions and investment income.

separate account. A special account established by an insurance company solely for the purpose of investing the assets of one or more plans. Funds in a separate account are not commingled with other assets or the insurance company for investment purposes.

service. Periods of employment taken into consideration under an employee benefit plan.

single employer plan. A plan sponsored by one employer.

split-funded plan. A plan funded through a combination of accumulated contributions and investment income and insurance contracts.

sponsor. In the case of a pension plan established or maintained by a single employer, the employer; in the case of a plan established or maintained by an employee organization, the employee organization; in the case of a plan established or maintained jointly by two or more employers or by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other group of representatives of the parties who have established or who maintain the pension plan.

stock bonus plan. A defined contribution plan under which distributions are normally made in stock of the employer, unless the distributee elects otherwise.

supplemental actuarial value. The amount assigned under the actuarial cost method in use for years before a given date.

target benefit plan. A form of money purchase pension plan under which the employer's annual contribution on behalf of each participation is the actuarially determined amount required to fund a target benefit established by a plan formula. The target benefit is usually based on compensation and length of service. For some target benefit plans, the substance of the plan may be to provide a defined benefit.

tax credit employee stock ownership plan. A profit-sharing or stock bonus plan established before 1987 that satisfies the requirements of section 409 of the IRC. The sponsor of such a plan is allowed a tax credit, rather than a deduction, for its contributions. Before 1982 these plans were commonly known as TRASOPs (for Tax Reduction Act Stock Ownership Plan), and the maximum allowable credit was based on the plan sponsor's investments that qualified for the investment tax credit. In 1982 TRASOPs were succeeded by PAYSOPs, under which the credit was based on the plan sponsor's payroll.

third-party administrator (TPA). A party unrelated to the plan who contracts to be responsible for plan administration.

thrift plan. A profit-sharing or stock bonus plan under which participants make after-tax employee contributions that are usually matched, in whole or in part, by employer contributions.

unallocated contract. A contract with an insurance company under which related payments to the insurance company are accumulated in an unallocated fund to be used to meet benefit payments when employees retire, either directly or through the purchase of annuities. Funds in an unallocated contract may also be withdrawn and otherwise invested.

unfunded plan. A plan whereby benefits are paid directly from the general assets of the employer or the employee organization that sponsors the plan.

unit of participation. An undivided interest in the underlying assets of a trust.

vested benefit information. The actuarial present value of vested accumulated plan benefits.

vested benefits. Benefits that are not contingent on an employee's future service.

wasting trust. A plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already-accrued benefits.

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